FINANCIAL INTEGRITY ACT OF 1981

HEARING

BEFORE THE

COMMITTEE ON GOVERNMENTAL AFFAIRS UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

FIRST SESSION

ON

S. 864

TO AMEND THE ACCOUNTS AND AUDITING ACT OF 1950 TO REQUIRE ONGOING EVALUATIONS AND REPORTS ON THE ADEQUACY OF THE SYSTEMS OF INTERNAL ACCOUNTING AND ADMINISTRATIVE CONTROL OF EACH EXECUTIVE AGENCY.

NOVEMBER 13, 1981

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FINANCIAL INTEGRITY ACT OF 1981

FRIDAY, NOVEMBER 13, 1981

U.S. SENATE,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, D.C.

The committee met at 1 p.m., in room 6226, Dirksen Senate Office Building, Senator Thomas F. Eagleton, presiding.

Present: Senators Eagleton and Sasser.

OPENING STATEMENT OF SENATOR EAGLETON

Senator EAGLETON. Good morning, ladies and gentlemen.

The Senate Committee on Governmental Affairs meets today to take testimony on S. 864, legislation intended to strengthen the internal accounting and administrative controls maintained by Federal agencies. This is not exactly a glamerous subject, but it is vitally important. Former Comptroller General Elmer Staats once called internal controls the first line of defense against fraud, waste, and program abuse, and he was entirely right.

I am grateful to Chairman Roth for scheduling this hearing and allowing me to preside over it.

Beginning with the GSA scandal, which surfaced in 1978, the public has been continually bombarded by reports of staggering levels of fraud, waste, and abuse in Federal programs. In one memorable revelation, the Inspector General at HEW estimated that between $6.3 and $7.4 billion was misspent annually at his Department as a result of fraud, abuse, and waste, to use his words, at a minimum.

An official of the General Accounting Office knowledgeable in this area estimated that same year that fraud in Federal programs could range anywhere from $12 to $25 billion annually.

This level of fraud, program abuse, and just plain waste in Federal programs is unacceptable. We cannot permit the squandering of billions of dollars at this time of continuing double-digit inflation and budgetary austerity. The misuse of Federal funds robs resources which might otherwise be available to meet legitimate, even pressing, human needs and it promotes understandable public cynicism about all Federal programs, eroding support for those activities.

There is no miracle, overnight cure to these problems. A Government as large as ours will never be perfectly administered, but there is a morally bankrupt, but widely held notion that stealing from the Government is somehow less bad than stealing from an individual.

But at the same time, billions of dollars lost to fraud, waste, and program abuse doesn't just happen. Those billions are lost because

of distinct, identifiable failings in performance by the Federal Government, and I believe that once those failings are identified and understood, we can devise workable solutions that would substantially improve the situation.

Since 1976, GAO has issued a series of reports showing that inadequate internal controls are the No. 1 problem facing Federal agencies. In August 1980, a report summarized the findings of GAO's reviews of 11 agencies' fiscal offices and found widespread, similar, and prevalent financial control weaknesses which caused GAO to believe that similar problems exist throughout the Government.

Horror stories abound where fraud, waste, and mismanagement can be directly attributed to inadequate internal controls. Let me cite just a few specific examples:

At the Labor Department's Employee Training Administration, action had not been taken to record auditors' exceptions to costs charged against grants. In May 1978, the agency had from 1,524 audit reports a total of $218 million in questioned costs that had never been recorded.

Another example is a financial clerk in the Department of Transportation embezzled over $856,000 in Federal mass transit funds. The clerk simply substituted his name on six vouchers instead of the names of the mass transit agencies supposedly receiving the money. His supervisor did not properly preaudit vouchers, but simply signed them over. The Government never discovered this fraud. It came to light only because of an alert bank teller who questioned the size of the deposits being made in the embezzler's account.

Another example is that over $25 million has been paid out erroneously because of internal controls weaknesses in the supplemental security income program, according to an August 1979, GAO report.

A final example: In hearings before Senator Chiles' subcommittee in 1980 indicated that over the last 10 years, Washington-based Federal agencies had bought $1.2 billion of new office furniture, even though $373 million worth of new or slightly used furniture was in storage. Agencies had no management systems to determine what furniture they had on hand before buying new items.

Regrettably, these cases where wrongdoing or a problem was detected represent only the tip of the iceberg. GAO has reported a total of 77,000 cases of fraud and other illegal acts alleged against 21 major agencies in the 2½ years ending in March 1979.

Very few of these cases involved brilliant, criminal minds executing elaborate foolproof schemes to defraud the Government and the public. Most of the illegal acts were probably perpetrated about as subtly as the clerk who passed himself off as a mass transit system: They occurred because internal controls had broken down, where commonsense, everyday procedures were not followed, presenting people with an open invitation to steal. It in no way excuses those who acted illegally to observe that a well-managed agency would not have given them the opportunity in the first place.

It is necessary to convince Federal managers that the responsibility to deliver funds and services carries with it the obligation to do so in a financially responsible way. This requires blasting loose some ingrained attitudes. As Mr. Staats said:

The reason internal controls systems are in a state of disrepair is that top management has devoted most of its concern and emphasis to delivering funds and services, and that effective controls over tasks and functions which lead to the delivery of these funds and services have had a low priority. Because of top management's insufficient concern for internal controls, middle management reflects this same indifference.

And top management's lack of concern reflects to some extent the low priority which Congress for too long accorded to internal controls and good financial management generally.

My commitment is to improving radically the current quality of internal controls maintained by the Federal agencies. While I have offered legislation to do so, my interest is in getting the job done, not in attending a White House bill signing ceremony. OMB takes the position that the necessary improvement in internal controls can be made administratively, and I'm trying to keep a relatively open mind on that issue.

OMB has recently issued Circular A-123 dealing with internal controls, and undoubtedly, some of the witnesses today will comment on that circular.

Hopefully, this hearing will enable the committee to make an informed judgment as to whether a goal we all seek, that is, improved internal controls in Federal agencies, whether it requires additional legislation or it can be accomplished by administrative means.

I am pleased to yield at this time to my colleague from Tennessee. I might say that no member of the Governmental Affairs Committee has been more vigilant and more dedicated in the pursuit of legislation and administrative reform to combat fraud, waste, and abuse than has Senator Sasser of Tennessee. I am delighted to have you at this hearing today.

OPENING STATEMENT OF SENATOR SASSER

Senator SASSER. Thank you, Mr. Chairman.

Mr. Chairman, I want to congratulate you for holding today's hearings on S. 864, the Financial Integrity Act of 1981. I am a cosponsor of this bill, which you introduced, Mr. Chairman, this session to build on all the work that we have done in the Governmental Affairs Committee during the last session of the Congress.

Now we are facing a truly great crisis in the Federal Government. There will be at least $35 billion cut in budget authority for the various departments and agencies in the coming fiscal year. The President is asking for even more reductions in the budget. And these diminished resources are accompanied by a drastic reduction in the number of full-time Federal employees.

In other words, the Federal Government may find itself severely strapped for money and manpower resources during the coming fiscal year.

We in Congress have spent a good deal of time here in this session in discussions on just how much the Federal Government should spend, and on what programs. This is just another dimension to good, financial management. The question comes, how well are the Government's resources being managed?

We are asking, in S. 864, for the Federal manager to adjust his green eyeshade and take a closer look at his agency, a closer look

at the department, a closer look at his or her program, because we want our Federal managers to give us an accounting of just how well they are managing the dollars and the personnel that they are given by the Congress.

We might say that this bill takes us back to the basic of fiscal management. Its principals, I think, could be found in almost any accounting primer. This kind of accountability is very much in line with the way some of our better corporations handle their fiscal responsibilities—I might say some of our more successful corporations. I quote from a letter we recently received from the American Institute of Certified Public Accountants. The letter says:

> It is becoming more commonplace for companies to include a management report in their annual report to shareholders. Such reports typically include comments on the system of internal accounting control.
>
> Accordingly, the American Institute of Certified Public Accountants support the concept of reporting on internal control by Federal managers as provided in S. 864, the financial Integrity Act of 1981.

This legislation takes a leaf from the ledger of private enterprise in instituting basic management controls for the Federal Government. The evidence is great that not enough attention has been paid by the Federal manager to these aspects of financial management.

For example, evidence gathered by the General Accounting Office and the Office of Management and Budget in response to initiatives and inquiries that I made during the last Congress show that the literally billions of dollars are lost each year by Federal agencies simply because of the failure to collect bad debts. Well, the reason is obvious: All the emphasis in the Federal Government is given to spending and putting out money to finance the programs—that's a legitimate function.

But scant attention is paid to managing and almost none to debt collection. No time was given to simple good husbandry of the agency's financial assets.

So strengthening the internal management controls of the Federal agencies which this bill that Senator Eagleton is in line with other initiatives of mine that clean up the debt collection mess and open up a nationwide General Accounting Office hotline so that concerned citizens can call to report instances of fraud, waste, and abuse. Mr. Chairman, again, I want to express my appreciation to you and to commend you for calling these hearings and say I look forward to working with you on this project as we have on many others, and I look forward today to hearing about insights on this legislation which I am confident these distinguished witnesses will give us.

Thank you very much.

Senator EAGLETON. Thank you, Senator Sasser. We, indeed, do have a list of very distinguished witnesses, the first of which is Mr. Charles Bowsher, the new Comptroller General of the United States. We welcome you, Mr. Bowsher. This is the first opportunity I have had to attend a hearing when you are testifying in your new capacity. We are delighted to have you here today.

TESTIMONY OF CHARLES A. BOWSHER, COMPTROLLER GENERAL, GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY RONALD POINTS, ASSOCIATE DIRECTOR, AFMD

Mr. BOWSHER. Thank you, very much, Mr. Chairman and members of the committee.

I am pleased to have this opportunity to appear before the committee on bchalf of the General Accounting Office to discuss the bill, S. 864, the proposed Financial Integrity Act of 1981.

As you point out, a seemingly unending disclosure of fraud, waste, abuse, and mismanagement in government during the 1970's has surfaced a serious crisis of confidence in the way Federal Government programs and agencies are managed. Federal departments and agencies cannot properly account for their activities without strong and effective control over operations. Internal control systems properly conceived, soundly based, and effectively monitored are the frontline defense against fraud, waste, and abuse.

The proposed Financial Integrity Act of 1981 was designed to strengthen controls by requiring management to monitor, to analyze, and to report on the adequacy of their systems of internal control.

The act would establish within each executive agency a continuous process of reviewing internal control systems, developing action plans for corrections, and reporting on the status of the control systems.

Implementation of this act should consist of three main phases: The initial review, the plan of action, and the annual review. During the first year, the Financial Management Division would review agency operations and provide the senior agency financial officer, such as the Assistant Secretary for Financial Managment, a summary of internal controls, strengths, and weaknesses of the various agency components.

The senior financial officer would review the detailed evaluation and prepare an overall assessment for the entire agency. At this point in the initial review process, the agency's Inspector General, the IG, would review the senior financial officer's report. This review would be for the purposes of validating the senior financial officer's report and providing the secretary or the agency head assurance that the report accurately reflects or presents the status of the agency's system of internal accounting and administrative controls.

Phase 2, which would be plan of action, that would consist of the senior financial officer analyzing the initial report and developing a plan of action to strengthen internal accounting and administrative controls.

The third phase would be an annual review of the prior year's progress in achieving planned internal control improvements and an analysis of the current internal control systems, including the status of the agency's progress in obtaining General Accounting Office approval of the accounting systems. The Inspector General would again play an important role by reviewing the senior financial officer's report and advising the agency head, such as the cabinet officer, whether the report accurately depicts the status of the

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internal control systems and of the progress in correcting those weaknesses.

As I mentioned, we view the requirements of this act as the basis of evolutionary improvements in the executive agency internal accounting and administrative control systems. Agencies need the continuous process required by this act to assess the internal control systems and implement needed corrections.

An important requirement of this bill is the periodic report prepared and signed by the head of the agency stating an opinion on the adequacy of the agency's internal control systems. The report would be required to be addressed to the President and made available to the Congress and to the public. This requirement would force Federal managers to give a higher priority to implementing effective internal controls and continually monitoring them to insure that strong controls are maintained.

Management of private corporations have begun including statements on their internal control systems in annual reports to stockholders, because the Federal Governnent encouraged them to do so. An international accounting firm recently published a study on management reports and included numerous examples of actual statements appearing in annual stockholders reports.

The following statement from the Xerox Corp. is one example included in the study.

I would like to quote:

> Xerox maintains a system of internal accounting controls designed to provide reasonable assurance that assets are safeguarded against loss or unauthorized use and that the financial records are adequate and can be relied upon to produce financial statements in accordance with generally accepted accounting principles.
>
> The concept of reasonable assurance is based on the recognition that the cost of a system of internal control must not exceed the related benefits. There are written internal accounting and operating control policies and procedures that are communicated to the Company's worldwide operating units. Adherence to these policies and procedures is constantly being evaluated by an extensive coordinated audit effort of our internal audit staff and independent certified public accountants.

This study illustrates the growing trend of reporting on internal controls by management in the private sector. In view of the increased recognition of the need for internal controls in the private sector, I believe the proposed Financial Integrity Act of 1981 is the legislation that could meet the same need and bring about significant improvement of internal controls in the Federal Government.

The requirements for Federal agencies to maintain internal administrative and accounting control systems have been mandated by law for over 30 years; however, most agencies have not given adequate priority to their internal control systems.

The General Accounting Office has issued literally hundreds of reports and studies that disclose the fact that most agencies are operating systems vulnerable to physical losses and waste of Federal property and money are susceptible to fraudulent or otherwise improper use of the Federal resources.

For example, one of our recent reports disclosed that over a 2½ year period, 21 Federal agencies experienced some 77,000 cases of known fraud. We estimated that the monetary loss totaled between $150 million and $220 million. Aside from fraud alone, waste and abuse can take an alarming toll of Government resources.

Three examples we have reported on include:

One, about $700,000 in overpayments were made by one agency because a preaudit of vouchers, which is a very basic control, was not performed.

Two, receivables totaling over $218 million in another agency went unrecorded resulting in no efforts being made to collect that amount; and,

Three, an overobligation of $205 million was made in one agency because of a serious breakdown in its accounting and financial management reporting systems.

The proposed Financial Integrity Act of 1981 will go a long way toward supplementing the existing legislation by providing the missing link of assurance that strong internal controls will exist. The passage of this act would, in simple terms, put teeth in the Accounting and Auditing Act of 1950, primarily since it would necessitate a continuous assessment of internal controls, plans of action to correct weaknesses, and annual reports on the adequacy of the internal control systems.

Obviously, costs will be incurred to realize the benefits to be achieved through implementation of this bill. It will mean a substantial investment in improved systems for many agencies and departments and will require educating management and employees to instill in them a keen awareness of effective controls.

However, we believe that the benefits and the savings will far outweigh the costs. Also, the Office of Management and Budget, as well as the Inspectors General, have already done some good work in this area.

We strongly support this bill, but we believe it could be strengthened if an item is added requiring agency heads to report to the Congress on the status and progress made in having their accounting systems approved by GAO at the time an appropriation is requested. This would provide the Congress direct oversight and feedback on an agency's internal control systems.

The basis for this recommendation stems from the fact that many Federal agencies' accounting systems have yet to be approved by the GAO. As you know, the Accounting and Auditing Act of 1950 requires GAO approval of the adequacy of all executive agencies' accounting systems. Accounting systems approval is based to a large extent on the adequacy of internal controls. Even after 30 years, only 63 percent of the Federal agencies' accounting systems have been approved.

In addition, we would like to offer four other suggestions for your consideration which would make S. 864 consistent with H.R. 1526, the Federal Managers' Accountability Act of 1981, which recently was passed in the House:

One, section 4 of the bill requires the Comptroller General to establish the required reporting systems and evaluation guidelines. We believe that the Director of the Office of Management and Budget should develop the reporting systems and evaluation guidelines. However, if the Congress believes the General Accounting Office, rather than the OMB should establish the required reporting systems and evaluation guidelines, we would have no objection;

Two, we also suggest that the deadline for establishing the reporting systems and the evaluation guidelines be extended 1 year to December 31, 1982;

Three, we agree that developing the standards for internal accounting and administrative control is a General Accounting Office responsibility. However, we believe section 4 could be clarified by requiring the agencies to establish internal accounting and administrative controls based on standards prescribed by the Comptroller General; and,

Four, section 4 should be clarified to require that all inadequacies or material weaknesses in the agency's internal control systems be identified and the plans and schedule for correcting any inadequacies be described in detail in the agency head's report required by subsection (d)(1).

In conclusion, I would just like to say that we believe the importance of this proposed legislation cannot be overstated. Effective internal controls help insure that Government managers know what their monetary and physical assets and resources are at all times; know how these assets are being used; how they are being dispensed and disposed of, and for what purposes; know that such purposes are authorized; and know that fraud, waste, and abuse are minimized and discouraged.

This proposed legislation would establish a badly needed discipline to assure close attention to the quality of internal controls and to enhance the accountability of Federal officials. Passage of the Financial Integrity Act of 1981 will serve to bring about the strong commitment necessary in the management of Government operations.

Mr. Chairman, this concludes my prepared statement.

I would be pleased to respond to any question you or other members of the committee may have.

Senator EAGLETON. Thank you, Mr. Bowsher.

Just for clarification, in the accounting profession, there is a precept, I guess, that is called generally and accepted accounting procedures; is that right?

Mr. BOWSHER. Generally accepted accounting principles.

Senator EAGLETON. Principles?

Mr. BOWSHER. Yes.

Senator EAGLETON. OK, and CPA's and accounting firms, et cetera, try to apply these evenhandedly throughout corporate America as their internal control systems are set up and implemented; is that correct?

Mr. BOWSHER. That is correct, Mr. Chairman.

Senator EAGLETON. Is there a bible for internal controls?

Is there a book or a set of books or a set of guidelines and principles that have been generally agreed to by professional accountants insofar as internal controls, and I will make that, first, in the private sector that we will call corporate America?

Mr. BOWSHER. There are auditing standards that have been set by the American Institute of CPA's and all the CPA firms abide by the auditing standards and the generally accepted accounting principles.

In addition, you have additional internal control guidelines produced by most of the major CPA firms.

Senator EAGLETON. All right.

Mr. BOWSHER. I also might point out, Mr. Chairman, that with the establishment of the Government Accounting Standards Board

[GASB] for the Government sector, which will be a comparable board to the FASB, I think we are soon going to be on the road to having something comparable to the private sector. With the auditing standards book that the GAO has produced, the "yellow book" as it is referred to, we have the auditing standards available for the Government sector now.

So, we are very close to being able to have the criteria that would be fairly uniformly accepted in the Government sector both for accounting and auditing standards.

Senator EAGLETON. You have anticipated my next question. We do not have as yet, as of today, a similar agreed-to set of internal controls in the Government sector, but we are moving in that direction; is that fair to say?

Mr. BOWSHER. That is right.

The General Accounting Office and the AGA formed a task force some time back which produced a very fine book on this subject. So there has been a lot of good work done. Again, I think we are close to being able to develop a uniform set of internal control standards.

Senator EAGLETON. Would it be your thought that if this legislation were to become law, that in time there would be these generally accepted, internal control procedures for governmental entities and they would apply uniformly throughout the totality of the Federal Government?

Mr. BOWSHER. Yes. I would certainly hope that eventually we would have a set of standards that would be pretty well accepted by all levels of government, the State and the local governments as well as the Federal Government.

Senator EAGLETON. Would it necessitate this legislation that is before the committee today in order to make that broadly and uniformly applicable across the length and breadth of the Federal Government?

Mr. BOWSHER. I think this legislation would go a long way in achieving it. It could possibly be done by administrative procedures, but I don't think it would be done as well as if this legislation was passed.

Senator EAGLETON. You mentioned the 1950 act and that 30 years later still one-third of the Federal Government is, for all practical purposes, not in compliance with the 1950 act. What, in this proposed bill—and you used the word teeth—what are the teeth in this bill as you see it to——

Mr. BOWSHER. The teeth in this bill is that the senior official, a Cabinet officer for instance, would have to have his people do that initial review, come up with the list of the weaknesses; develop a plan of action, and then on an annual basis, report as to how well they are doing in making the corrections and coming up with an adequate system of internal and accounting controls.

I think once you did that, then it would be a very simple matter of having GAO approval of the accounting systems.

Senator EAGLETON. So we are not going to send him to jail or anything like that?

Mr. BOWSHER. No.

Senator EAGLETON. But a competent general manager would be behooved to sign a report year after year saying, "Dear GAO," "Dear OMB," or "Dear Mr. President," whatever, "Once again I

am not in compliance with the uniform control"—or whatever—"and I am sorry. I will try to do better next year." A competent manager would be behooved to sign such a letter year after year after year. That is the therapeutic value of the bill as you see it?

Mr. BOWSHER. That is right. Also, when you consider how frequently many senior management positions turn over in Government, the accounting systems and internal controls just aren't up there as a top priority. I don't believe it should be a mere certificate, where you are trying to get somebody to sign something that does not exist; namely, that everything is OK.

There has been some concern with this legislation that we would be trying to force Cabinet level officers to sign a certificate, just one paragraph or two paragraphs, I don't think that should be in the intent at all.

It should be where do you stand now, what has to be fixed, and what progress are you making?

Senator EAGLETON. Is it true that two of the agencies are not in compliance, even now, with the 30-year old act, are HHS and DOD?

Mr. BOWSHER. That is correct.

Senator EAGLETON. In another context, with respect to DOD, when we are considering inspector general Legislation, DOD goes to great pains to point out that their operations, their procedures, their functions are so dissimilar to a normal civilian agency that an IG for DOD is a different kettle of fish than an IG for a civilian agency. Passing that issue, let me apply it to internal controls.

Is there any reason, because of the nature and structure and functioning of the Department of Defense, why its systems of internal controls should be any different than the Department of Education's, the Department of Energy's, or some other civilian department's?

Mr. BOWSHER. There might be some unique items with the weapons, but there is no reason at all why Defense shouldn't have an adequate set of internal controls and approved accounting system.

Senator EAGLETON. I point out that in a previous capacity you held a position in the Department of Defense; what was that?

Mr. BOWSHER. Assistant Secretary of Navy for Financial Management.

Senator EAGLETON. For Financial Management.

Mr. BOWSHER. I might say I strongly believe that the Defense Department should have their accounting systems approved.

Senator EAGLETON. One other question: You mentioned in your testimony that to bring all of this into being is going to cost some money. I don't think we should pass over that lightly. I also point out, for the record, that you have been deeply involved before becoming Comptroller General with the project of redoing the books, records, and accounting procedures for the District of Columbia. You and I and others have worked in that field, now, for about 5, 6 years.

Bearing in mind the length that that project took, and still, by no means is it final; bearing in mind the cost of that project, which, frankly, was a greater cost than I had originally anticipated, but nonetheless, the costs were incurred; and bearing in mind that that is just one entity, a pretty big one, the District of Columbia government, but nonetheless, one entity, when I think of the time, effort,

and complexity of that undertaking for one governmental entity, the District of Columbia government, and the effort, expertise that are necessary. the numbers of outside consultants and professionals that were necessary, it, at least momentarily, boggles my mind if I were to think that we would undertake that for the totality of the Federal Government.

I don't think it could be done in the 21st century, using all 100 years thereof. Am I making--because that is so much on my mind and still fresh on my mind—am I making too big a thing about what that might teach us insofar as the totality of the Federal Government as far as internal controls is concerned?

Mr. BOWSHER. No; I think your concern is well placed. I think one of the advantages of this bill is that you are asking the Federal Government to improve their internal control and accounting systems on agency by agency, department by department basis. In other words, we are not trying to develop a standard Federal system for the whole Federal Government with one big effort. What you are really doing is asking each agency head and the senior financial officer at each agency to work out a plan to develop and overcome their control weaknesses of their department systems. So, take the Department of Army, for example, which had a substantial problem a few years ago in overobligations and losing control of their procurement appropriations. I am told that they have made real progress because they mounted a major effort recently, and it has cost money.

But I think again, the cost-benefit there has probably been proven. I would think that the cost-benefit ratio should be looked at in each of these systems. As these plans are developed, department by department, agency by agency, one of the things you will be looking at is the cost-benefit that you expect to get out of the effort that you are going to put into improving the controls and getting them up to where they should be.

So I think by taking a department by department look, you are not taking on something that cannot be handled. I think that is a much better approach, as this bill does, rather than trying to do something across the Federal Government.

Senator EAGLETON. I have consumed about 12 minutes of questioning. I will yield at this time to Senator Sasser and then come back with some additional questions.

Senator SASSER. Thank you, Mr. Chairman.

Mr. Bowsher, 34 months ago, at my urging, the General Accounting Office set up a national fraud hotline to give the private citizen a means of assisting the Government in the fight against fraud and waste and abuse.

Now, this fraud hotline has been very successful during its operation so far. It has uncovered millions of dollars in wasteful practices and even some fraudulent Government spending, which has been turned over, as I understand it, to the Department of Justice.

Don't you think the Financial Integrity Act is an important tool that could enable us to better follow up on complaints about wasteful or fraudulent spending that are uncovered by the fraud hotline?

Mr. BOWSHER. Yes, I do, Senator. I also think that if we had this act, and we had improvements over a 5- to 10-year period, I would hope we would have fewer callers complaining about lack of con-

trols and wasteful spending. I would hope with passage of this act, that we would have better control over Government spending and Government programs.

Senator SASSER. Mr. Chairman, for your information, if you are on the road and want to call the National Fraud Hot Line, the number is toll free, 800-424-5454.

Senator EAGLETON. Can you get sports results? [Laughter.]

Senator SASSER. General Bowsher, your predecessor, Elmer Staats, who was a distinguished and dedicated public servant, if I have ever known one, called internal controls and I quote him "The first line of defense against fraud, waste, and error in Government programs."

Yet in all the years that General Staats tried so diligently, he wasn't able to effectively introduce internal controls into the Federal Government. He found, the General Accounting Office found, under his direction, that more than 10 billion Federal dollars could be collected immediately through a more vigorous pursuit of misused Federal funds or by collecting outstanding debts that are owed to the Government.

If S. 864 were enacted, how long would it take to establish a vigorous pursuit such as that envisioned by Elmer Staats? When could we expect some results?

Mr. BOWSHER. I think it would take 2 to 3 years to do the reviews, to get the programs developed and get going. I think that you probably would not see the results until maybe the 3d, 4th, or 5th year. It takes that long, I believe, to do this type of work.

But the real payoff would be the following years thereafter, because it would be a continuous process. You would be getting continously more control over the Federal Government operations and, as I say, it would really be putting the teeth in the Accounting and Auditing Act of 1950, which I think is what General Staats was referring to. He said something like S. 864 really needed to get the process moving.

Senator SASSER. Would not passage of this act help improve the work of the various inspectors general?

Mr. BOWSHER. I would think that this would be a major program area that the inspectors general would spend a fair amount of time on, and the payoff would be great.

Senator SASSER. In that regard, could you give us your latest assessment on how well the inspector general system is working?

Mr. BOWSHER. I'm afraid, Senator, that I have only been in office 5 weeks. I really have not had enough exposure to it. I have attended one meeting of the Council on Integrity where they all reported, and they seemed to be working on very good things and doing well, but I just have not done any review myself or have any facts to give you for an appraisal at this point.

Senator SASSER. Are you in a posture to give us any indication or any idea of how well the departments are working with the IG's in an effort to root out fraud, waste, or abuse?

Mr. BOWSHER. No, we really don't, Senator, at this point.

Senator SASSER. That would be an interesting subject for, perhaps some future discussion on down the line, just to see how well the Inspector General program is working and whether or not the departments themselves are cooperating and working closely with

the various IG's in an effort to do something about the problem of fraud, waste, and abuse in the Federal Government.

Thank you. Mr. Bowsher.

Mr. BOWSHER. Thank you, Senator.

Senator EAGLETON. Mr. Bowsher, do you have any concern that the reporting requirement will simply produce some general statement of assurance rather than a certification backed by an extensive assessment of the strengths and weaknesses of the controls?

Mr. BOWSHER. I do have some concern along those lines. I think that is why the role of the IG, and an oversight control by the Comptroller General and the General Accounting Office, would be necessary to insure that those kinds of statements aren't prepared on an annual basis by the various departments.

Senator EAGLETON. I would like to probe a little further on this question of costs. There is a GAO report, August 25, 1980, which comments in several places that written procedures were adequate, but that there was a failure to follow them. This implies problems that could be solved without great cost by agency management which demonstrates its commitment to making the process work.

Would you comment on that?

Mr. BOWSHER. Yes. I think that is very true. In other words, by just going through the process of review and identifying some of those areas, you could actually get quite a bit of improvement without doing costly systems work.

Senator EAGLETON. Obviously the situation will vary from agency to agency, but are we talking mainly about problems that can be solved by simply tightening up, or are we talking about the installation of entirely new, often complex, computerized systems, again, getting back to my analogy about the District of Columbia books and records?

Mr. BOWSHER. It is probably a mixture. I would think we could get quite a bit accomplished by tightening up. At some point, however, some of the systems would have to be done.

Senator EAGLETON. Now, the reporting required called for in the bill before this committee would impose on the agency head requirements, which have been analogized by some, to the requirements imposed by the Foreign Corrupt Practices Act on corporation executive officers. First of all, do you agree that there is some analogy between what is before us and the Foreign Corrupt Practices Act?

Mr. BOWSHER. There is some analogy, but I don't think that is a complete analogy, because other movements or pressures, were brought on the private sector to move in this direction in addition to the Foreign Corrupt Practices Act.

Senator EAGLETON. How much of what large corporations are doing in the area of internal controls is done in response to the FCPA requirements, and how much has been undertaken voluntarily?

Mr. BOWSHER. I would say that a good part of it is done to comply with the urgings of the SEC. At the same time, I think many in management, after the problems that came up in the private sector in the late 1960's, the early 1970's, wanted to insure they had good internal controls, and they welcomed these procedures.

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Senator EAGLETON. Is it not the case that the SEC has recently pulled back on a proposed rule in this area allegedly because of concern about costs and paperwork?

Mr. BOWSHER. Yes. They pulled back in some respect, but the SEC still urging the private companies to develop adequate systems of control: "The SEC is still very interested in public reporting on internal accounting controls and would reconsider rulemaking in this area."

According to this E&W report, 51 percent, in 1979, were reporting on their internal controls. Then last year it went up to 63 percent. What the SEC is really saying is, "What you are doing out there is so good, we are going to let you do it. We are not going to put our official rulemaking and force it on you."

Senator EAGLETON. Dr. Harper from the OMB is going to testify after you, and I think you have perhaps had an opportunity to review his prepared statement. Dr. Harper argues that it is appropriate for OMB to issue guidance to the agencies concerning internal controls, and the GAO involvement and advice in this area, to quote him, "would be confusing to the agencies and could be detrimental to our efforts to strengthen agency systems."

Could you comment on that point made by Dr. Harper?

Mr. BOWSHER. Yes. I think we could work it out where there would be none—we could properly coordinate with the OMB people. As I stated in my statement, they should run the program. They are in the executive branch. They should have the responsibility to make sure that the agencies are running this program properly. We would only develop the standards, and I think we could coordinate very well with the OMB and there would be no confusion.

Senator EAGLETON. Finally, Dr. Harper opposes the reporting requirement which the legislation would impose on the agencies. Do you think the burden that he envisions is a realistic concern?

Mr. BOWSHER. I think it's a concern, but the advantages of the legislation, the permanence of the reporting requirements and the involvement of the top people in having to make an annual report, would far outweigh that concern.

Senator EAGLETON. Senator Sasser?

Senator SASSER. No further questions, Mr. Chairman. Thank you.

Senator EAGLETON. Thank you very much, Mr. Bowsher. If we have some additional questions of a technical nature, we will submit them to you in writing and I would appreciate a response for the record.

Mr. BOWSHER. Thank you very much.

Senator EAGLETON. Our next witness is Dr. Harper, the Deputy Director of the Office of Management and Budget.

Dr. Harper, we welcome you, and you may proceed.

TESTIMONY OF EDWIN L. HARPER, DEPUTY DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET, ACCOMPANIED BY HAL STEINBERG, ASSOCIATE DIRECTOR FOR MANAGEMENT, AND JOHN LORDAN, CHIEF, FINANCIAL MANAGEMENT BRANCH

Mr. HARPER. Thank you very much, Mr. Chairman. I am very pleased to be here.

This is a very important topic. I am gratified that you would give us the opportunity to appear again. As you know, we testified last May on this subject and I personally wanted to come and appear before your committee to emphasize the fact that the Office of Management and Budget believes that the subject of internal controls and the objectives that you have laid out in your legislation are, indeed, very, very important.

We certainly concur inthe view expressed several times here this morning, that internal controls are the first line of defense against fraud, waste and abuse.

We do feel it is our responsibility to act vigorously in this area.

If I may, I will summarize my statement and submit it in detail for the record. Also, I would like to introduce my colleagues. I am proud to have with me this morning Mr. Hal Steinberg, who is our associate director for management, a former senior partner of one of the big eight accounting firms, and Mr. John Lordan, the chief of our financial management branch, and very experienced in this entire area.

The objectives of the act we have testified about before. We heartily concur in those objectives and endorse them fully. We have just issued a new directive for the Circular A-123 on internal control systems. I would like to offer it to the committee for inclusion in the record.[1]

Senator EAGLETON. So ordered.

Mr. HARPER. Thank you.

Because of the importance that I attach to internal controls, I took a special interest in the preparation of this circular. I do believe the circular will contribute significantly to tightening up agencies' systems of internal controls.

Let me review for you briefly what we mean by internal controls and the types of weaknesses in control systems that we are trying to correct. The internal controls are simple safeguards that can be easily overlooked, things like separating certain duties, authorizing payment for checks; having control totals built into computers; counting the inventory periodically and comparing the results to the records; documenting all transactions. Of course, when these safeguards are missing, the stage is set for fraud and waste.

Here are some examples: Because duties were not properly separated in the Department of Defense, about $130,000 in fraudulent checks were issued by those involved in payroll operations. Another example: Missing control totals allowed computers in HHS to spew out benefit checks totaling $500,000 in excess of the amounts due. Another example: The failure to make periodic inventories in Department of Energy laboratories resulted in $80,000 of expensive electronic test equipment disappearing without a trace.

Poor documentation of financial transactions allowed a nursing home operator to charge $60,000 for oil paintings in his home. One that is really astonishing is in the social security area: Here, a computer matching project, which we have recently initiated, revealed that the Social Security Administration has continued to pay benefits to persons long since deceased and those benefits have amounted to, we estimate, some $24 million. One other example: A

[1] See p. 31.

Government car was outfitted with 15 different sets of tires in its first 32,000 miles of traffic.

These are examples of how little things can result in a lot going wrong.

Neither the proposed legislation nor our circular can be expected to prevent all cases of fraud and waste. Rather, what we are trying to do here is create an atmosphere in which agency managers will be aware of the need to establish systematic controls, monitor their application, and review periodically their effectiveness. Our circular attempts to do that by requiring the following actions: By March 31, each agency head is required to issue an internal control directive based upon the standard set forth in the circular, but tailored to specific agency circumstances.

Agency heads will make clear assignments of internal control responsibility and assure the accomplishments or failures are reflected in individual performance appraisals on which their pay and their bonuses are calculated.

Each agency will establish a review plan to insure that all operations are surveyed by December 31, to determine areas of vulnerability to financial loss, errors in reporting, and illegal unethical acts.

Followup action will begin immediately in problem areas to streamline or strengthen controls. Major instances of fraud or other financial losses, as well as breakdowns in control systems, will be reported on agency heads.

These are the things that are in our internal control circular. We have also taken the following actions to tighten up on agency systems: We have required each of the major agencies to update their fund control regulations and submit them to OMB for approval under the Antideficiency Act. Thirty-four such systems have been approved by the Director of the Office of Management and Budget thus far.

As a result of this program, there has not been a single case reported to us of a major overobligation or overexpenditure in this administration.

We cut $4.5 billion out of agency budgets that was attributable to fraud and waste.

We developed a model control system for audiovisual equipment as part of implementing Bulletin No. 81-16, "Elimination of Wasteful Spending on Government Periodicals, Pamphlets, and Audiovisual Products."

This one control system, we expect, will save the taxpayers $100 million over the 3-year period.

We worked closely with the Inspectors General and other members of the Council on Integrity and Efficiency to develop tough enforcement programs. In the first 6 months of fiscal 1981, our auditors and investigators realized $99 million in recoveries and penalties and brought in more than 600 indictments and 400 convictions for fraud against the Government.

We are also working with professional groups like the American Institute of CPA's Committee on Government Internal Controls and the Association of Government Accountants' Task Force on Internal Control.

We plan to follow up promptly with the major agencies on the new internal control circular. Next week, for example, we are meeting with representatives of the agencies to make sure they understand their responsiblities under the circular. In addition, we are asking them to report the status of their own internal control systems. We believe that all of the actions that we have taken are consistent with the objectives of your bill, S. 864. Moreover, we believe that in many ways, they will work better than a legislative approach. Of major concern to us in S. 864 are the provisions calling for the Comptroller General to establish a system of agency guidance and the provisions calling for agency heads to render an annual report expressing an opinion on the adequacy of their internal systems.

We believe the agency guidance should be issued by the executive branch rather than by the Comptroller General because internal control is an executive branch responsibility.

As discussed earlier, such guidance has now been issued by OMB and is being implemented by the agencies.

We believe this approach keeps the responsibility for internal controls focused on where it belongs, in the executive branch, and on the individual manager within the executive branch. Furthermore, it gives the Congress the opportunity to hold us fully accountable for the accuracy of internal control systems.

Furthermore, it leaves the Comptroller General free to consult with us on agency guidance, while retaining his independence to review our performance.

Moreover, the issuance of additional or conflicting guidance now by the Comptroller General, we feel, might be confusing to the agencies and could be detrimental to our efforts to strengthen agency systems.

With regard to annual reports, this aspect of S. 864 is similar to requirements the Securities and Exchange Commission recently attempted to impose on private corporations with respect to the Foreign Corrupt Practices Act. Because of the great difficulty executives had expressing opinions on entire corporate systems, the SEC has pulled back from its requirements.

As we understand it, this approach would have caused a tremendous amount of paperwork and expense, and it dealt only with financial controls, not with compliance with laws and regulations as would be the case under S. 864.

We would hate to see this private sector experience duplicated in the Government, just at a time when we believe we are beginning to make some real headway in eliminating unnecessary Government paperwork and redtape.

Mr. Chairman, I believe we have made a great deal of progress on the subject of internal controls since my earlier appearance before you and this committee. I hope you will agree, and I hope you will give us, the administration, a chance to make its approach work before giving further consideration to legislation.

That completes my statement. I would be happy to answer any questions you may have.

Senator EAGLETON. Thank you, Dr. Harper.

For my edification, under the 1950 act, the law that we are operating under, what standards are established in that act, and who establishes them; GAO, OMB, or what?

Mr. HARPER. If I may, I would like to have John Lordan address that. John wasn't here in 1950, but almost.

Mr. LORDAN. Mr. Chairman, the 1950 act required the head of each department and agency to establish and maintain a system of internal control. The act did not establish standards, nor did it give either the GAO or OMB responsibility for establishing standards.

Senator EAGLETON. Do you consider that to be a failing that the 1950 act says to each department, "Do your own thing and have at it"?

Mr. LORDAN. Mr. Chairman, the departments clearly, after 1950, and since then have established many systems of internal control. I think the proposed legislation, our proposed administrative initiative is intended to highlight the importance of these controls in this period.

I don't think it is necessary to look at the earlier act as a complete failure. It probably did a great deal of good in its day. There is probably a need, now, to update that and get some more progress moving.

Mr. HARPER. Mr. Chairman, if I may, one thing that concerns me a little bit in our discussion of internal controls and internal control systems is, I think, that there is a temptation to view internal controls as some kind of a theoretical system that you lay down on top of operations, and, of course, that is really not the case.

An internal control might be as simple a thing as putting a bad lock on the supply cabinet so people don't walk away with stuff, or as we indicated earlier, separating responsibility for authorizing a check from writing the check. So it is not as if departments and agencies don't have many, many limits of internal controls.

What we have attempted to do is to, through our circular, systematize the review and monitoring of the internal control activities in a department; to clearly focus responsibilities to make sure that the management realizes that they are responsible for it, not the GAO, not the Inspector General, not the Office of Management and Budget; but that the internal manager is responsible for his internal controls and it is the IG's job to check up on him; to see that those systems are in place.

So in addition to the followup, checking up, we have set standards in our circular which we think describe the fundamental elements that must be in any internal controls system.

As I have indicated, we want to lead off with an assessment of vulnerabilities so we know where those weak spots are and we can go after them.

Senator EAGLETON. I think that is a valuable observation.

Mr. Lordan, you said at the tail end of your response to my earlier question something to the effect that the 1950 act served its purpose well back in that point of time, but that there was a need to update that act.

The bill before us, as well as H.R. 1526, is an attempt to update that act. If it is flawed in the respect that Dr. Harper has testified, what do you view, Mr. Lordan, as the areas in which additional legislation is needed to update the 1950 act?

Mr. LORDAN. Mr. Chairman, I think the act establishes the basic framework which is adequate for the issuance of administrative guidance.

The circular that Dr. Harper referred to earlier, OMB Circular A–123 cites the act of 1950, as well as the Anti-Deficiency Act of 1956, as two of its legislative underpinnings, and then as he indicated, to establish interagency systems and a system for review, monitoring, and evaluation of the systems that are in place or that need to be put in place.

Senator EAGLETON. I will just go back to Dr. Harper.

The Circular A–123 as we know it, is the only guidance that you are giving to the agencies in the area of internal controls.

If that is the case, if it is just general guidance, do you really think that the agencies will become confused in some way if GAO fleshed out the limited and rather general guidance found in that circular?

Mr. HARPER. I think our guidance represents general principles and general guidance that needs to be applied specifically through the multifaceted activities of Government that are—we appreciate that the Federal Government does everything from running railroads to dental clinics, and buying a locomotive and accounting for that and controlling for locomotives is a little bit different than controlling for dental floss at the Defense Department's dental clinic.

I think that we don't want to get into the trap of saying that from a central location, we are going to dictate every single element of internal control. The key to, I think, internal control systems is the fact that you have got a system, and you have got it documented. Then if you have got it documented, the auditors can come in and say, "All right. Here is what your system said you were going to do; that you were going to have this guy authorize the check and that guy sign the check. Did you, in fact, do that?"

So if we have got the documentation of the system, I think that is one of the most important elements of having an internal control system in place.

Mr. STEINBERG. I might add that while GAO is not here to speak for themselves, I would doubt if they can expand very much on the guidance, because we would both start from the same perspective, which is the extensive materials that have been developed by the American Institute of Certified Public Accountants. That was part of the task force that helped develop the circular.

Senator EAGLETON. Should we be terribly comforted with Circular A–123, although we welcome it, when we realize that we would have had, for 30- years, a law on the books, and, as of now, a third of the Government is not in compliance with the 30-year-old law? How do we anticipate they will be "in compliance" with Circular A–123?

Mr. HARPER. I think that maybe we are dealing with slightly different concepts when we are talking about internal control systems with the General Accounting Office's accounting systems standards because an accounting system does not entirely match all the criteria. GAO's systems certification does not necessarily mean that it is automatically a bad system.

The accounting systems can appreciate, for an organization such as the Defense Department, spending a couple of hundred billion dollars a year is a fairly complex activity.

There is much in the way of accounting theory that goes into what should a good accounting system really be. Some of the fundamentals of generally accepted accounting practices don't necessarily apply to accounting practices in the Federal Government.

On the other hand, it has always been the case, since before the founding of the Republic, that the managers in this Government have been responsible for controlling the goods and funds entrusted to them by the taxpayer.

Senator EAGLETON. Am I to take it that the fact that 37 percent of the agencies' accounting systems are not yet approved by the GAO as required by that 1950 act, that that doesn't trouble you, or do you think that the GAO is just nitpicking about this, or what?

Mr. HARPER. I think that there would be advantage to having all of the executive branch accounting systems certified by the GAO.

On the other hand, I think that it is a matter of priority, and I think that our work in the internal controls area, our activities of Inspectors General, frankly, are a higher use of resources that would be a slavish adherence to trying to satisfy various accounting conventions and theories, some of which are, I think, still in an evolutionary stage.

Senator EAGLETON. You just mentioned Inspectors General. That causes me to ask this.

On that 12 percent across-the-board cut the President recommended or referred to in his September speech, this proposed cut apparently included the Office of Inspector General, at least, at that time. Since that time, there have been some rumors, I guess, that these offices were to be exempt from that 12 percent cut or at least reviewed on a case-by-case basis. Can you give me an update? Where do the IG's stand vis-a-vis that 12 percent proposal?

Mr. HARPER. We sent a recommendation—it is fairly rare in the annals of OMB history—to the agencies, recommending to then that the personnel resources of the Inspector General offices be held at a level not lower than the fiscal 1981 level of operation.

I think there are one or two exceptions to that. One is the Community Services Agency's Inspector General, which is phasing out. I think in the case of GSA, the Administrator had decided earlier this year that he could do with about five less slots. The Defense Department, on the other end, made a substantial increase in the personnel allocated to its designated Inspector General.

Senator EAGLETON. Just to pursue that one question further, do you support the concept of giving the IG offices a separate line item in the budget? In most budgets, perhaps in all of them, they do not have a line item.

Mr. HARPER. I think it is—I don't have an accurate count on top of my head, but it does split—I'm tempted to say its 50-50 between individual line items and being lumped in with the Office of the Secretary. Frankly, I'm not sure that one way or another is superior to the way the Appropriations Committee addresses the issue.

Senator EAGLETON. Finally, on the IG question, we have been waiting for some time for the administration to make up its mind on proposals to expand the IG legislation to include the IG's in the

Departments of Defense and Justice and Treasury. When might we expect to have the administration's proposal with respect thereto?

Mr. HARPER. I think shortly.

Senator EAGLETON. Even if we recognize that the prime responsibility for internal control rests with the agency and the agency head, why would that precept be undercut by the reporting requirement envisioned in the legislation before us?

Mr. HARPER. Well, Comptroller General Bowsher mentioned in response to one of the questions that there is some concern about certification as to whether or not this report was tantamount to certifying, by an agency head, that all was right in every outpost of whatever agency it was, and some concern that he was accepting a responsibility, or accepting a liability, which would be very difficult to personally certify every case.

There is some subtleties, which perhaps, my colleague, Mr. Steinberg, would like to make in the differences between certifications and opinions since I believe that public accountants give opinions, but don't certify things generally.

Mr. STEINBERG. They both get people in trouble. I think General Bowsher and yourself alluded to one of the major problems and that is, that to go to the reporting or certification step would require a tremendous cost to review the systems of internal control that are completely under the control of the agency head.

With internal control, one of the basic standards—in fact, one of the ones that is in our circular, and one of the ones, I think, GAO believe in, too—is cost-effectiveness. Internal controls should never cost more than the amount of losses they are going to prevent, and if one of the things that you are looking for to make sure we have internal controls is the type of review that enables an agency head to say, "Yes, they are adequate for these purposes," it would require a tremendous cost to be able to do the evaluation to make such a determination, probably far more than it is worth.

Senator EAGLETON. I am concerned about the cost aspect of it, and I fully agree with you that the controls that we set up or you or GAO or others set up should be no more complex or no more costly than the threat of abuse that would result from the absence of controls.

As you all were present in the room, I am mindful of the experience with respect to the cost of setting up the recordkeeping for the District of Columbia. We hope that those sizeable costs prove themselves to be moneys well spent. This committee is not interested in just requiring every agency to buy millions and millions and millions of dollars' worth of sophisticated equipment and elaborate recordkeeping systems, et cetera, if that would not be a positive expenditure of public moneys.

Mr. STEINBERG. Mr. Chairman, I might add that as long as you referred to the District of Columbia that, to my knowledge, they never even went to the full extent that you are talking about, which was a letter from the mayor and city manager commenting on the adequacy of internal controls, and yet they were able to make the improvements in the internal controls which enabled an audit firm to render an unqualified opinion on financial statements, just through paying attention to improving the systems of control, which is exactly what our circular is destined to do.

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Senator EAGLETON. Dr. Harper, paragraph 8–G of the circular states:

> These procedures should also include reports to the agency head on all significant internal control breakdowns and financial losses in accordance with criteria established by the agency head.

Then in paragraph 10 it is noted that:

> Agencies may be required to include information on financial losses, system breakdowns and progress in making system reviews as part of their annual reports to OMB on financial management improvement.

There is no provision for reports to the President or to the Congress or to the public. Here is my question: Given the record of what I guess would be fair to call lethargic performance in the agencies with respect to internal controls, does your circular leave too much discretion in the agencies and provide too little evidence of what is occurring to OMB, not to mention the President or the Congress or the public?

Mr. HARPER. We feel, first of all, that requiring the report to the agency head and focusing on it in that way would insure the involvement of our Inspector General program, which you and some of your colleagues played such an important role in creating in the first place. We feel that is a very essential and important element of an internal control system.

Thus, we feel that, at the agency level, the combination of the direct report to the agency head and the activities of the Inspector General, that those kinds of problems will be focused upon and remedied.

The only reason that we made the paragraph 10 permissive rather than mandatory was that we thought we would reserve a final decision on that each year, that it may be, for example, we do a special project with the Inspector General, it may be that 1 year, there are other emphases that we want to place. So that is the only reason we have written the circular this way. We wanted not to mindlessly generate a lot of extra paper.

Senator EAGLETON. Senator Sasser inquired of Mr. Bowsher as to what his evaluation was of the functioning and efficacy of the Inspectors General and General Bowsher, just being on the job for 5 weeks, reserved comment on that question. You have been very closely associated with Inspectors General in terms of recruitment, et cetera, of new Inspectors General and shepherding the legislation that is before the Congress, et cetera.

Could you give this committee your appraisal of the performance of Inspectors General and what it has meant insofar as better management, better pursuit of fraud, waste, and abuse, et cetera?

Mr. HARPER. I am a great supporter of the Inspector General program. I think it has made a tremendous contribution to the better management of the Federal Government, and I do, indeed, sincerely applaud you for your role in creating that program and the other members of this committee who, I know, regard this with a special parental interest and fondness.

I think you have something that you can, indeed, be proud of. I think that the results of the first semiannual consolidative report of the Inspectors General that we issued in July showed, there, that in the first 6 months of this fiscal year, they were responsible

for bringing hard cash, not just kind of theories, but hard cash, almost $100 million, back into the Government, which is about half of the cost of the program. That doesn't mention the tremendous savings in terms of dollars not spent, programs evaluated and found to be ineffective.

Obviously, there is a great harmony of interest between the activities of the Inspectors General and the interest of the Office of Management and Budget. We have keen interest in knowing what programs are effective, where dollars are not being spent on the highest and best priorities, and thus, we do have a natural harmony and interest and communicate well with the Inspectors General and the agency heads.

I think that the second semiannual report due towards the end of this year will show a steady strong progress in that program and that, indeed, it is making major contributions towards eliminating fraud, waste, and abuse in Government.

Senator EAGLETON. Mr. Lordan, there is a report of the Legislation Review Committee, Interagency Internal Control Task Force on Draft Legislation on Internal Control—Financial Integrity Act of 1980. Are you familiar with that?

Mr. LORDAN. Mr. Chairman, is that a report submitted to the OMB Internal Control Task Force?

Senator EAGLETON. Yes.

Mr. LORDAN. Yes, sir. I am familiar with that.

Senator EAGLETON. It is dated August 1980, and it bears your signature, at least on one page thereof, and we will make it a part of the record.

That is all we have. Thank you, Dr. Harper.

Mr. HARPER. Thank you, Senator.

[The prepared statement of Mr. Harper, OMB directive for Circular A-123, and the report of the Legislative Review Committee follow:]

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

FOR RELEASE ON DELIVERY
Expected at 9:30 a.m.
November 13, 1981

STATEMENT OF
EDWIN L. HARPER
DEPUTY DIRECTOR OF THE OFFICE OF MANAGEMENT AND BUDGET
BEFORE THE SENATE GOVERNMENTAL AFFAIRS COMMITTEE

Mr. Chairman and Members of the Committee:

I am pleased to meet with you again to discuss the question of how best to strengthen Federal controls against fraud and waste. As you recall, we discussed this subject on May 19, 1981. At that time, I indicated that we in the Administration support the objectives of S. 864 -- The Financial Integrity Act.

However, we also testified that we believed the objectives of the Act could be achieved more efficiently and effectively by administrative means. We pointed out that we were considering an OMB directive to the executive departments and agencies that would provide guidance on establishing and monitoring systems of internal control. We said that the new directive, and other actions we were taking, would obviate the need for the proposed legislation.

The new directive has just been issued. It is OMB Circular No. A-123, "Internal Control Systems," and I would like to offer it to the Committee for inclusion in the record of this hearing. Circular A-123 was developed with the assistance of an interagency task force representing more than 20 executive departments and agencies as well as

representatives from the General Accounting Office. Drafts of the Circular were provided to the staff of this Committee and other interested Committees in both Houses. Public comment was obtained, and extensive consultations were held with affected parties in the agencies. Because of the importance I attach to internal controls, I took a special interest in the preparation of the Circular. I believe it will contribute significantly to tightening up agency systems of internal control.

Let me review for you what we mean by internal controls, and the types of weaknesses in control systems we are trying to correct. Internal controls are simple safeguards that can be easily overlooked, things like:

-- separating certain duties (e.g., authorizing payments from issuing checks);
-- having control totals in computers;
-- counting the inventory periodically, and comparing the results to the records;
-- documenting all transactions.

When these safeguards are missing, the stage is set for fraud and waste. Here are some examples:

-- Because duties were not properly separated, payroll clerks in the Defense Department were able to authorize and issue $130,000 in fraudulent checks to themselves and friends.

-- Missing control totals allowed computers in HHS to spew out benefit checks totalling $500,000 in excess of amounts due.

-- Failure to make periodic inventories in DOE labs resulted in $80,000 worth of expensive electronic equipment disappearing without a trace.

-- Poor documentation of financial transactions allowed a nursing home operator to charge the Government $60,000 for oil paintings for his home.

-- Social Security continued to pay $24 million in benefits to persons long-since dead.

-- A Government car was outfitted with 15 sets of tires in 32,000 miles.

Neither the proposed legislation nor our Circular can be expected to prevent all cases of fraud or waste. Rather, what we are trying to do is to create an atmosphere in which agency managers will be aware of the need to establish systematic controls, monitor their application, and review periodically their effectiveness. The Circular attempts to do that by requiring the following actions:

-- By March 31, each agency head is required to issue an internal control directive -- based upon the standards set forth in the Circular, but tailored to specific agency circumstances.

-- Agency heads will make clear assignments of internal control responsibility and assure that

accomplishments or failures are reflected in individual performance appraisals (on which pay and bonuses are calculated).

-- Each agency will establish a review plan to ensure that all operations are surveyed by December 31, to determine areas of vulnerability to financial loss, errors in reporting, and illegal or unethical acts.

-- Followup action will begin immediately in problem areas to streamline or strengthen controls.

-- Major instances of fraud or other financial losses as well as breakdowns in control systems will be reported to agency heads.

In addition to the issuance of the Internal Control Circular, OMB has taken the following actions to tighten up agency systems:

-- We required major agencies to update their fund control regulations and submit them to us for approval under the Antideficiency Act. Thirty-four such systems have been approved by the Director to date. As a result of this program, there has not been a single case reported to us of a major overobligation or overexpenditure in this Administration.

-- We cut $4.5 billion out of agency budgets that was attributable to waste and mismanagement.

-- We developed a model control system for audiovisual equipment as part of implementing Bulletin No. 81-16, "Elimination of Wasteful Spending on Government Periodicals, Pamphlets, and Audiovisual Products." This effort alone is expected to save $100 million over a three-year period.

-- We worked closely with the Inspectors General and other members of the Council on Integrity and Efficiency to develop tough enforcement programs. In the first six months of fiscal year 1981 our auditors and investigators realized $99 million in recoveries and penalties, and brought in more than 600 indictments and 400 convictions.

-- We are working with professional groups like the new American Institute of CPAs Committee on Government Internal Controls and the Association of Government Accountants' Task Force on Internal Control.

-- We plan to follow up promptly with the major agencies on the new internal control Circular. Next week we are meeting with representatives of the agencies to make sure they understand their responsibilities under the Circular. In addition, we will be asking them to report on the status of internal control systems as part of their annual reports on financial systems improvements.

We believe all these actions are consistent with the objectives of S. 864. Moreover, we believe they will work better than the legislative approach. Of particular concern in S. 864 are the provisions calling for the Comptroller General to establish a system of agency guidance, and the provisions calling for agency heads to render an annual report expressing an opinion on the adequacy of their control systems.

We believe agency guidance should be issued by the executive branch, rather than by the Comptroller General because internal control is an executive branch responsibility. As discussed earlier, such guidance has now been issued by OMB and is being implemented by the agencies. We believe this approach keeps the responsibility for internal control focused where it belongs, in the executive branch, and gives Congress the opportunity to hold us fully accountable for the adequacy of internal control systems. It leaves the Comptroller General free to consult with us on agency guidance, while retaining his independence to review our performance. Moreover, the issuance of additional, or conflicting, guidance now by the Comptroller General would be confusing to the agencies and could be detrimental to our efforts to strengthen agency systems.

With regard to annual reports, this aspect of S. 864 is similar to requirements the Securities and Exchange Commission attempted to impose on the private sector under

the Foreign Corrupt Practices Act. Because of the great difficulty executives had expressing opinions on entire corporate systems, SEC had to pull back from its requirements. As we understand it, this approach would have caused a tremendous amount of paperwork and expense, and it dealt only with financial controls, not compliance with law and regulation, as would the case under S. 864. We would hate to see this private sector experience duplicated in Government, just at a time when we are making real headway in eliminating Government paperwork and red tape.

Mr. Chairman, I believe we have made a lot of progress on internal control since my earlier appearance before you on the subject. I hope you agree, and I hope you will give the Administration a chance to make its approach work before giving further consideration to legislation.

That completes my statement. I would be glad to answer any questions you may have.

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

October 28, 1981 CIRCULAR No. A-123

TO THE HEADS OF EXECUTIVE DEPARTMENTS AND ESTABLISHMENTS

SUBJECT: Internal Control Systems

1. Purpose. This Circular prescribes policies and standards to be followed by executive departments and agencies in establishing and maintaining internal controls in their program and administrative activities.

2. Background. The Budget and Accounting Procedures Act of 1950 requires the head of each department and agency to establish and maintain adequate systems of internal control. The Antideficiency Act, 31 U.S.C. 665, requires that agency systems for the control of funds be approved by the Director of OMB. Despite these statutory requirements, there continue to be numerous instances of fraud, waste, and abuse of Government resources and of mismanagement of Government programs. These problems frequently result from weaknesses in internal controls or from breakdowns in compliance with internal controls.

3. Policy. Agencies shall maintain effective systems of accounting and administrative control. All levels of management shall involve themselves in assuring the adequacy of controls. New programs shall be designed so as to incorporate effective systems of internal control. All systems shall be evaluated on an ongoing basis.

4. Definitions. For the purpose of this Circular, the following terms are defined:

a. Agency -- any department or independent establishment of the executive branch.

b. Agency Component -- a major organization, program, or functional subdivision of an agency having one or more separate systems of internal control.

c. Internal Controls -- the plan of organization and all of the methods and measures adopted within an agency to safeguard its resources, assure the accuracy and reliability of its information, assure adherence to applicable laws, regulations and policies, and promote operational economy and efficiency.

d. Internal Control Documentation -- written policies, organization charts, procedural write-ups, manuals, memoranda, flow charts, decision tables, completed questionnaires, software, and related written materials used to describe the internal control methods and measures, to communicate responsibilities and authorities for operating such methods and measures, and to serve as a reference for persons reviewing the internal controls and their functioning.

e. Internal Control System -- the totality of the methods and measures of internal control for all or part of an agency.

f. Vulnerability Assessment -- a review of the susceptibility of an agency or program to loss or unauthorized use of resources, errors in reports and information, illegal or unethical acts, and/or adverse or unfavorable public opinion.

g. Internal Control Review -- a detailed examination of an agency's or agency component's system of internal control to determine whether adequate control measures exist and are implemented to prevent or detect the occurrence of potential risks in a cost effective manner.

5. Responsibility. Designing, installing and monitoring internal control systems for their effectiveness and identifying and initiating needed changes is the responsibility of the agency head. The Inspector General, or his equivalent in agencies without an Inspector General, also has a responsibility in regard to internal controls, as explained in paragraph 5b.

a. Agency heads are responsible for the establishment and maintenance of a system or systems of internal control within their agencies. This responsibility includes determining that the system is functioning as prescribed and is modified, as appropriate, for changes in conditions.

Each agency head shall issue an internal control directive (if one does not exist) and a review plan by March 31, 1982 (see paragraph 8). Where additional internal control directives are required for agency components, the head of the agency shall ensure that such directives are consistent with the agency directive.

b. The Inspector General, or the senior audit official where there is no Inspector General, will, in conjunction with internal audits, review internal control documentation, systems, and compliance to determine whether the policies and standards established by this Circular are being implemented properly. Reviews should also be made of the audit follow-up system in order to ensure management's follow-up of audit findings and recommendations. Additional reviews will be performed as necessary to provide sufficient agency coverage.

6. Objectives of Internal Control. The objectives of internal control are to provide management with reasonable, but not absolute, assurance that financial and other resources are safeguarded from unauthorized use or disposition; transactions are executed in accordance with authorizations; financial and statistical records and reports are reliable; applicable laws, regulations and policies are adhered to; and resources are efficiently and effectively managed.

7. Standards of Internal Control. Certain basic standards shall be adhered to in the system(s) of internal control established by an agency or agency component. These include: documentation, recording of transactions, execution of transactions, separation of duties, adequate supervision, access to resources, competent personnel, and reasonable assurance.

   a. Documentation -- Internal controls, accountability for resources, and all financial transactions shall be clearly documented, and documentation shall readily be available.

   b. Recording of Transactions -- Transactions shall be recorded as executed, when executed, and be properly classified.

   c. Execution of Transactions -- Independent evidence shall be maintained that authorizations are issued by persons acting within the scope of their authority and that transactions conform with the terms of the authorizations.

   d. Separation of Duties -- Key duties such as authorizing, approving, recording transactions, issuing or receiving assets, making payments, and reviewing or auditing shall be assigned to separate individuals to minimize the risk of loss to the Government. Internal control depends largely on the elimination of opportunities to conceal errors or irregularities. This in turn depends on the assignment of work in such a fashion that no one individual controls all phases of an activity or transaction, thereby creating a situation that permits error or irregularities to go undetected.

   e. Supervision -- Qualified and continuous supervision shall be provided to assure that approved procedures are followed. Lines of personal responsibility and accountability shall be clear.

   f. Access to Resources -- Access to resources shall be limited to authorized personnel. Access includes both direct physical access and indirect access through the preparation or processing of documents that authorize the use or disposition of resources. Periodic comparison shall be made of the

resources with the recorded accountability to determine whether the two agree. The frequency of the comparison shall be a function of the vulnerability of the asset.

g. Competent Personnel -- Reasonable care shall be taken that key personnel have high standards of integrity, and are competent, by education, training or experience to accomplish their assigned duties.

h. Reasonable Assurance -- Internal control systems shall provide reasonable, but not absolute, assurance that the objectives of the system will be accomplished. This standard recognizes that the cost of internal controls should not exceed the benefits derived therefrom, and that the benefits consist of reductions in the risks of failing to achieve the stated objectives.

8. Requirements for Agency Internal Control Directive and Plans. An agency directive and accompanying plan required by paragraph 5 will, at a minimum:

a. Identify an appropriate official, establish an internal control committee, or otherwise establish specific responsibility for seeing that agency internal control systems are developed (where they do not exist), maintained, reviewed, and improved as necessary.

b. Provide for coordination between program managers and technical staffs, including the Office of Inspector General or its equivalent in agencies without an Inspector General, in matters concerning internal control.

c. Assign responsibility for internal control to specific officials in each component of the agency and provide that performance appraisals reflect accomplishments of this responsibility.

d. Require each internal control system to meet the standards of internal control described in paragraph 7.

e. Provide a plan by March 31, 1982 for vulnerability assessments covering all agency components to be accomplished by December 31, 1982, and as frequently as circumstances warrant thereafter, but not less frequently than biennially. Such assessments should be used to determine when and in what sequence reviews of the effectiveness of internal controls should be performed and systems improved or documented.

Vulnerability assessments should consider, but need not be limited to, the following: newness of the program, dollar value of the program, nature of the program and its clientele, recent changes in program control or resource levels, impact of the program on persons or organizations external to the agency, the appreciation for effective internal control by

persons operating the program, assumed effectiveness of existing controls, recent instances of errors or irregularities, and the interval since the most recent evaluation or audit.

f. Provide for internal control reviews on an ongoing basis to determine whether the controls are operating as intended and are effective. These reviews should identify internal controls that need to be strengthened or streamlined. They should be a part of normal management and budget analyses and should draw on available audit reports and other sources.

The frequency of the reviews shall be determined by the Inspector General and/or the agency head. The Inspector General may do a review at any time.

g. Establish administrative procedures to enforce the intended functioning of the internal controls. Included in the procedures should be notations in performance appraisals for positive accomplishments related to internal controls, appropriate disciplinary actions for violations of internal controls, and correction of internal control weaknesses, however identified.

These procedures should also include reports to the agency head on all significant internal control breakdowns and financial losses, in accordance with criteria established by the agency head. Reporting and discipline for lesser violations may be handled at lower levels.

9. Specific Internal Control Guides. Models and other guidelines for internal controls for specialized aspects of agency operations will be developed from time-to-time and issued separately to aid agencies in designing specific internal control systems.

10. Reporting. Agencies may be required to include information on financial losses, system breakdowns and progress in making system reviews as part of their annual report to OMB on financial management improvement.

11. Effective Date. This Circular is effective on publication.

12. Inquiries. All questions or inquiries should be addressed to the Financial Management Branch, Office of Management and Budget, telephone number 202/395-4773.

13. Sunset Review Date. This Circular shall have an independent policy review to ascertain its effectiveness three years from the date of issuance.

David A. Stockman
Director

REPORT OF LEGISLATION REVIEW COMMITTEE, INTERAGENCY INTERNAL CONTROL TASK FORCE, ON DRAFT LEGISLATION ON INTERNAL CONTROL (FINANCIAL INTEGRITY ACT OF 1980)

1. INTRODUCTION. The Legislation Review Committee was assigned the task of reviewing the draft legislation related to the proposed Office of Management and Budget (OMB) Circular on Internal Control; providing material describing pros and cons of alternatives; and to make a recommendation whether or not OMB should support the legislation, if and when it is formally introduced in the Congress.

The Committee held several meetings to review and discuss the proposed legislation. In addition, discussions by members of the Committee were held with staff of the Comptroller General, two Inspector General's offices, and two of the Congressional committees associated with the draft legislation. The results of the meetings and discussions are incorporated in the body of the report.

The Legislative Review Committee included the following task force members:

Robert Kessler, DOT, Chairman
Susumu Uyeda, JFMIP
Terrence McMahon, AID
Milton Zall, HUD

2. DRAFT LEGISLATION - WHAT DOES IT DO? The draft legislation (now proposed as S. 3026) amends Section 113 of the Accounting and Auditing Act of 1950 (31 U.S.C. §66a) for the express purpose "To ensure that the requirements of subsection (a)(3) of this section are fully complied with." This subsection states that "The head of each executive agency shall establish and maintain systems of accounting and internal control designed to provide effective control over and accountability for all funds, property, and other assets for which the agency is responsible, including appropriate internal audit."

The proposed legislation then provides guidance on a series of actions that culminate in the preparation of an annual report by the head of each executive agency in which the agency heads state an opinion on the adequacy of the systems of accounting and administrative control. The Comptroller General, in consultation with the Director of OMB, is given the responsibility to establish performance guidelines and report format. The definition of "internal accounting and administrative controls" is the sole responsibility of the Comptroller General. The draft bill gives the Inspector General (or the head of the internal audit staff if no Inspector General exists) the responsibility to "receive and investigate any allegation that an employee of the agency provided false or misleading information in connection with the evaluation of the agency's systems of internal accounting and administrative control or in connection with the preparation of the annual report---." To summarize the draft bill, it proposes additional legislation to mandate compliance with existing legislation and to require certification by agency heads on a periodic basis that sound internal controls have in fact been established and are being followed.

3. BACKGROUND INFORMATION ON PROPOSED LEGISLATION. There were three Congressional subcommittees actively involved with the draft legislation. In the Senate, under the Committee on Governmental Affairs, Senator Chiles' Subcommittee on Federal Spending Practices and Open Government and Senator Eagleton's Subcommittee on Governmental Efficiency and the District of Columbia were both actively interested in the legislation. In the House, under the Government Operations Committee, Congressman Brooks' Subcommittee on Legislation and National Security is interested in the legislation.

In addition, the public accounting firm of Price Waterhouse and Company met frequently with Congressional subcommittees supporting the proposed legislation in terms of credibility in the financial and management area of the Federal Government. It is our understanding that the draft legislation distributed to the Internal Control Task Force at the June 5, 1980 meeting was initially drafted by Price Waterhouse with some slight revisions made by Congressional staff and the General Accounting Office. An updated version of the draft bill was subsequently prepared and was less onerous in its administrative requirements. This updated draft was subsequently introduced by Senator Eagleton on August 6, 1980, as S. 3026 (copy attached).

In our discussion with Congressional staff, they recognized that they are dealing in an administrative area that is difficult to define and describe; and, that ideally the subject should be handled by the Executive Branch through organizational and procedural techniques and disciplines. Nevertheless, they (Congressional staff) question the administrations' sincerity and desire to move in this area, as well as its ability to make the individual agencies produce results. The hill staffers also were concerned that many Government accounting systems are still not approved and that high incidence of operational abuse and mismanagement is being reported. There was some indication that Senator Chiles' staff was not fully convinced that this is a legislative matter. However, Price Waterhouse approached Senator Eagleton's subcommittee, who are very interested in the subject, and the Senator introduced the legislation on August 6, 1980, as S. 3026. At the time this report was prepared, hearings were being planned for the first week in September.

As additional background, in a draft of a prepared statement on behalf of the Association of Government Accountants to be presented to the House Committee on Government Operations (relating to proposed legislation to amend the Inspector General Act), the AGA will strongly support enactment of the Financial Integrity Act. As of the date of preparation of this report, the draft statement was being reviewed by AGA's Financial Management Standards Board.

4. PROS AND CONS. There follows a list of pros and cons relating to the proposed legislation, followed by some general observations on the bill.

a. Pro

- It will force OMB to actively work with agencies to ensure adequate internal controls in the Government, and agency officials to focus more directly on the subject of improving internal controls.

- A formalized structure will be created for the review of internal financial and administrative control systems within the agencies.
- It will emphasize Congressional concern over the high incidence of reports of waste, fraud, and mismanagement.
- It will help assure prompt corrective action to reports issued by the Comptroller General, the Inspector Generals and internal audit staffs.
- Compliance with the legislation should accelerate the approval of agency accounting systems.
- Even if legislation is not enacted, the mere possibility of it will act as a driving force for action by the OMB. (This was an observation made by a Congressional staff person.)

b. Con.

- It should not be necessary to enact additional legislation to motivate compliance with existing legislation.
- The legislation could in some instances produce a superficial overview of systems in general with each annual report expressing satisfaction that the agency internal accounting and administrative controls are generally adequate.
- The ability to resolve questions related to findings by the Inspector Generals that "there is reasonable cause to believe that false or misleading information was provided" is of serious concern. This is especially true in determining "reasonable cause."
- The ability to formally and systematically review all systems of internal and administrative controls in a short time frame is highly questionable. If the requirement is that all agency systems be reviewed annually, we do not believe it is physically possible.
- Implementation could result in the creation of a new "management audit" organization in addition to the Inspector General organizations, even though the Inspector General legislation was to consolidate existing auditing, investigation, and inspection activities. One of the responsibilities of the new IG offices is to conduct continuing evaluations of systems of internal control.
- The pressure of legislative compliance without additional staffing will result in numerous consulting contracts, especially if there is not an orderly phased approach to the required reviews.

c. General Comments.

(1) It is interesting to note recent events on this subject in the private sector. The Securities and Exchange Commission (SEC) had proposed a rule that would have required registered companies to

state in annual disclosure documents whether their internal accounting controls are adequate to comply with the Foreign Corrupt Practices Act. Most of the 950 comment letters on the proposal argued that such reviews would be too costly. As a result, the SEC withdrew its proposed rule and gave the companies and their internal auditors three years to develop voluntary disclosures and ways to monitor internal controls.

(2) The Inspector General Act of 1978 (P.L. 95-452) had as one of its purposes "to provide a means for keeping the head of the establishment and the Congress fully and currently informed about problems and deficiencies relating to the administration of such programs and operations and the necessity for and progress of corrective action." The semiannual report required under this law provides the vehicle for reporting internal control deficiencies. In addition, section 305 of Public Law 96-304 (Supplemental Appropriations and Recission Act, 1980) requires resolution of all unresolved audits. One of the IG offices informally advised that the estimated cost to perform a selective review of internal controls would be 15 staff years. Another IG office wrote "our present procedures for planning and scheduling audits should provide adequate audit coverage of the Department's systems of internal controls."

(3) OMB's Financial Priorities Program and the establishment of the Interagency Internal Control Task Force should be evidence that the Executive Branch has made a firm commitment in this area, and the administration should be given sufficient time to demonstrate the results of their efforts.

5. ALTERNATIVE LEGISLATION. As a general statement, we do not believe legislation of administrative actions or to enforce existing legislation is desirable. However, if legislation is the only way acceptable to the Congress, then we would suggest that the Inspector General Act be amended to require the Inspector General's semiannual report to contain an opinion on the adequacy of the Agency's system of internal accounting and administrative control for those activities audited during the reporting period. Since his report is available to the Congress and the public, it will provide adequate disclosure as intended by the draft bill under review. This alternate legislation, coupled with OMB's Circular on internal control should be more than adequate to demonstrate positive action on the subject of internal control. (It is noted that this proposed alternative was not unanimously supported by all committee members.)

6. RECOMMENDATION. It is the opinion of this committee that the Office of Management and Budget should oppose enactment of the bill based on constitutional provision of the separation of power between the Legislative and Executive Branches. As a general statement, we believe that any legislation specifying administrative actions to carry out existing legislation should be opposed by the Executive Branch. The opposition to the bill should be based on the administration's actions under the Financial Priorities Program, including the proposed or implemented procedures under the OMB Internal Control Circular. If the Congress is still intent on passing the legislation, some language in the bill should be provided to allow OMB and the agencies to pinpoint high risk areas for priority review, instead of the annual across-the-board review that is required in the proposed legislation.

Respectfully Submitted,

Robert H. Kessler

Robert H. Kessler, Chairman
August 15, 1980

Senator EAGLETON. The next witness coming forward will be Mr. Fletcher Lutz, executive vice president, Association of Government Accountants, Arlington, Va.

Mr. Lutz?

TESTIMONY OF W. FLETCHER LUTZ, EXECUTIVE VICE PRESIDENT, ASSOCIATION OF GOVERNMENT ACCOUNTANTS, ACCOMPANIED BY GILBERT SIMONETTI, JR., CHAIRMAN, LEGISLATIVE AFFAIRS BOARD, ASSOCIATION OF GOVERNMENT ACCOUNTANTS

Mr. LUTZ. Mr. Chairman, I am W. Fletcher Lutz, executive vice president of the Association of Government Accountants, an organization of professional financial managers having more than 12,000 members, dedicated to improving financial management at all levels of government.

I am joined by Gilbert Simonetti, Jr., the chairman of the AGA's Legislative Affairs Board and a partner in the accounting firm of Price Waterhouse.

We appreciate the opportunity to appear before your committee to present our views on S. 864, the Financial Integrity Act of 1981, which, among other things, would amend the Accounting and Auditing Act of 1950 to require public reporting on the adequacy of systems of internal accounting and administrative controls by heads of executive agencies.

We fully and strongly support this proposal. We believe that issuance of such annual representations by top level Government officials, and, more importantly, the substantive work that would have to be done in order for those representations to be made, will significantly improve the financial management of Government funds and will help restore confidence in our public institutions.

Moreover, it would provide substance rather than theory to the basic concept that the heads of departments and agencies must take responsibility for their actions—in other words, they would be accountable in some measurable degree to the public they serve.

Following are our principal reasons for endorsing S. 864.

The administration and the Congress continue to wrestle with the difficult and painful process of cutting the Federal budget, and certainly this is unavoidable if Government spending is to be reduced. But, there is another aspect to Government finances besides how much is spent and for what. That is, how well are the Government's resources managed and accounted for?

Unfortunately, too often the answer to this question is, "not well at all." The most visible and troubling result of this situation is the large number of reports from so many sources that billions of dollars have been lost as a result of fraud, waste, and mismanagement.

The correction of this situation is at present one of the most immediate and promising approaches to reducing the Federal Government's squandering of the country's limited resources. We commend this committee for its action in addressing this problem.

One indication of inattention to sound financial management in Federal Government agencies is the fact that, 30 years after the Accounting and Auditing Act of 1950 required that the General Ac-

counting Office (GAO) approve accounting systems in all Federal agencies, only 64 percent of those systems have received such approval.

Among the accounting systems that have not received GAO approval are the largest and most important systems of the Department of Defense and the Department of Health and Human Services, which together account for more than half of the Federal budget.

Through follow-on reviews, the GAO has also found widespread weaknesses in accounting systems that had been approved. In some cases, agencies have either not implemented proposed systems as approved or have allowed approved systems to deteriorate.

Why do situations like this continue? Here we share the view of former Comptroller General Elmer Staats. He has stated that the major reason internal control systems are in a state of disrepair is that top management has devoted most of its concerns and emphasis to the delivery of funds and services, and that effective controls over the tasks and functions which lead to the delivery of these funds and services has had a low priority.

This attitude, which inevitably filters down through the organization, also has had a demoralizing effect on Government financial managers. As a result, many of them are frustrated in their efforts to carry out one of their principal functions—safeguarding public assets.

Congress has been presented over the last few years with abundant evidence of this attitudinal problem, and its costly results. Further, this evidence is not, in any way, abating. For example, the title of a January 1981 GAO report, "Disappointing Progress in Improving Systems for Resolving Billions in Audit Findings," speaks for itself.

According to that report, the Government is losing billions of dollars because of failure by various agencies to act on audit recommendations. The report has identified $14.3 billion in unresolved audit findings representing potential recoveries, rebates, revenues, and savings for the Federal Government.

Other enormous losses of Government funds have occurred due to failure to collect debts owed the Federal Government. This situation has been attributed primarily to the fact that top agency management's attention to debt collection is inadequate. Inattention in this area is only one more symptom of the problem that has been cited repeatedly by witnesses before numerous hearings on Federal Government accountability, that is, the preoccupation by agency personnel with delivery of services and disbursement of funds, resulting in an inadequate emphasis on financial management.

It is disturbing that some Federal managers are not making efforts to recover lost funds, even when such losses are specifically identified. It is much more disturbing that there is a lack of attention to effective financial management which would help prevent fraud, waste, and mismanagement from occurring in the first place. We strongly believe that prevention has a much bigger payoff than detection with corrective action.

An absolute requirement in order to achieve such preventive financial management is the implementation of effective systems of internal accounting and administrative control, which is a major

objective of S. 864. Such systems can properly safeguard Government funds and property both by decreasing the potential for abuse and by making detection of its occurrence easier.

Many Government officials have emphasized the need for such controls. The former Comptroller General frequently remarked on the importance of internal controls in Government, and he has given examples of the types of fraud, sometimes amounting to millions of dollars annually, which can occur in the absence of even the most fundamental controls.

In further support of his contention, Inspector General and GAO investigations have been turning up numerous cases of fraud and abuse resulting from inadequate internal controls.

Distressingly, as a result of its investigation of 11 Federal agencies, GAO has concluded that internal control weaknesses pervade the Federal Government. Moreover, the Office of Management and Budget reported to Congress last year that "very few agencies have comprehensive systems of internal control," and that "controls required by existing systems may not be properly observed."

Ever since the GSA fraud scandal broke in the summer of 1978, we have had repeated revelations of fraud, waste, and mismanagement in Federal Government programs, and repeated statements on the ineffectiveness of internal controls and inattention to sound financial management practices in Federal agencies.

The most recent and comprehensive study is the GAO's report, "Fraud in Government Programs, How Extensive Is It? How Can It Be Controlled?"

The second volume of the report was released in September of this year, and there is one more volume to come. In performing an analysis of 21 Federal agencies, the GAO identified over 77,000 instances of fraud during the 2½-year period from October 1, 1976 through March 31, 1979. And the GAO's recommendation for controlling such fraud, as set forth in volume I, dated May 7, 1981, is distressingly familiar:

> Good systems of internal controls would prevent much of the fraud, or at least detect it sooner. However, controls over Federal programs are often inadequate, nonexistent, or ignored.

Now it is time to stop compiling evidence and take action.

While some efforts have been made to improve control systems in Government agencies, they can only be considered a piecemeal approach to more effective action. Something much more fundamental is needed—and that is the promotion of a positive control environment.

We believe requiring chief executives to report publicly, in writing, over their own signatures, on the adequacy of internal control systems in their respective departments and agencies, S. 864 will go a long way toward improving the financial management of Government funds.

If this requirement is enacted, it is reasonable to expect that agency heads will assume more formal responsibility for the quality of their organizations' internal control systems and will set a newer, higher priority for overall good financial management which will filter from top executives down through the organization.

When agency managers and employees at all levels realize that their chief executives are putting their own names on the line in attesting to the integrity of basic systems which safeguard taxpayers' dollars, they will want to insure that the work supporting such attestations is thorough and accurate, that the work is independently tested and evaluated by inspections and audits, and that identified weaknesses are promptly corrected.

We recognize and support the efforts that OMB has made in attempting to promote sound financial management in the Federal Government. We applaud OMB's financial priorities program, and its release on October 28, 1981, of Circular A-123, which prescribes policies and standards for establishment and maintenance of internal controls in executive departments and agencies.

By mandating public reporting on internal controls at the highest agency levels, the proposed legislation will strengthen what OMB is in the process of accomplishing.

We also endorse the provisions of the proposed legislation regarding strengthening the role of the Inspectors General. We believe it appropriate that the Inspectors General receive and investigate any allegations that an employee of the agency provided false or misleading information in connection with the evaluation of or reporting on internal accounting and administrative controls. It is also essential that disciplinary or corrective action be taken by the head of the agency where the results of the investigation disclose that such is warranted.

As you know, the companion bill to S. 864, H.R. 1526, "The Federal Managers' Accountability Act of 1981," passed the House of Representatives on May 18. While essentially identical to S. 864 in overall objective, the House bill contains several specific differences.

First, the Director of the Office of Management and Budget, rather than the Comptroller General, is given primary responsibility for developing guidelines for performing control evaluations and establishing a system for internal control reporting.

Second, the stipulation that executive reports on internal controls be made available to the public is qualified to guard against disclosure of confidential or classified material.

Third, a new requirement, not in S. 864, that the appropriations requests of executive department and agencies include a report on the status and progress made in having accounting systems approved by the Comptroller General in accordance with section 112 of the Budget and Accounting Act of 1950; and

Finally, a requirement that annual budgets submitted to Congress by the President contain statements detailing changes made in the budgets requested by each Office of Inspector General.

We agree with the first three of the above provisions in the House bill and recommend that these changes be incorporated into the Senate committee's bill. As to the fourth provision, we are not competent to comment on any legal or jurisdictional objections which have been raised concerning reporting on budget requests by Offices of Inspectors General. However, we believe that it is essential and cost-effective for Inspectors General to have the resources needed for them to do their jobs adequately and we recognize that Congress has a responsibility to help insure that this happens.

Mr. Chairman, this concludes my prepared statement. I shall be pleased to answer any questions you or members of the committee may have.

Senator EAGLETON. Thank you, Mr. Lutz. Your organization, the Association of Government Accountants, I gather, had some input in the formulation of Circular A-123, is that correct?

Mr. LUTZ. Yes; through our members and through their agencies.

Senator EAGLETON. Yes; the essence of Dr. Harper's testimony is that the legislation before us isn't needed, that in essence, that Circular A-123, if fully honored, et cetera, would do the job.

Since you and your folks had some input into A-123, why don't you think A-123 suffices for the present?

Mr. LUTZ. Senator Eagleton, one of the problems that we see with the administrative direction is that this will really not accomplish the task. Again, as the Comptroller General said this morning, there are changes in those top executive positions more frequently than any of us would like, but that, alone, will make it difficult to keep up with those controls if something is not put in writing and that therefore, the attention is paid by those top executives to internal controls.

Now, as to this organization and its views on A-123, we believe that through legislation, there will be a permanency to maintaining good internal controls. There really will be a strengthening of a process to continue development and implementation of controls. It will not depend on who is on hand and makes it happen or not.

Senator EAGLETON. Very good. That is, the circular is perhaps easy to ignore, a statute, wherein one has to actually attest to or certify to one's compliance or explain why they are not in compliance is more beneficial?

Mr. LUTZ. Very definitely, sir.

Senator EAGLETON. What about the cost-benefit question that was raised by Dr. Harper which does, in fact, trouble me?

Mr. LUTZ. All right. Senator, we never said nor do we believe that you get these things for free. You do not. We definitely know there is a cost, but I would just like to raise one issue. If you are going to administratively do something, or do it because of law, the costs are still there. I mean, there is no less cost, no different cost; that is the point.

We do not believe we should spend more to accomplish the control than the control is worth. We believe those things are measurable, they are demonstrated day in and day out, and they ought to be followed through in subsequent review to determine if we spend too much money on those controls for what you get out of them.

Remember that in most of these instances when a control is put into a system, it lasts forever. The initial cost of putting it in should be spread over a long period of time, and the review costs are very minimal.

Mr. SIMONETTI. Mr. Chairman, if I may comment on the two questions that you raised?

Senator EAGLETON. Yes.

Mr. SIMONETTI. The other factor in A-123, which is not addressed is the responsibility of the chief executive of the agency. Circular A-123, does not contain a responsibility on the agency head. The

agency head himself does not have the specific responsibility for reporting on internal controls as called for under the legislation.

I think there may be some misunderstanding cerning the illusion that has been made to the private sector. In the private sector, the chief executive officer is taking responsibility with respect to the internal control systems and comments on them in the management reports that you heard described earlier by Comptroller General Bowsher. The issue concerns the relative responsibilities of a large company having billions of dollars, comparable, say, in size, to a large Government agency having billions of dollars. It would seem there should be as much responsibility placed on the chief executive of a public sector entity on behalf of taxpayers as we expect to have on a private sector entity on behalf of the stockholders.

The other point is on cost. It occurs to me—and your point is valid with respect, of course, to the District of Columbia—we are talking here about possible losses of some $10 to $25 billions of dollars annually attributed to fraud, waste, and abuse. I don't know how much will be saved by the implementation of improved control systems, but from a public policy point of view, to do nothing is to suggest that we are willing to absorb a cost which is the loss due to fraud, waste, and abuse, to the tune of $10 to $25 billion.

It would seem to me there is a midground of cost-benefit relationship.

Senator EAGLETON. That is very well put, and I appreciate that. That puts forth a very important observation.

Thank you gentlemen very much.

Mr. LUTZ. Thank you.

Mr. SIMONETTI. Thank you.

Senator EAGLETON. Our final witness will be Mr. John K. Watsen from the Institute of Internal Auditors.

TESTIMONY OF JOHN K. WATSEN, INSTITUTE OF INTERNAL AUDITORS, WASHINGTON, D.C.

Mr. WATSEN. Mr. Chairman, my name is John Watsen. I am the immediate past president of the Washington Chapter of the Institute of Internal Auditors, and the Director of Auditing of the Federal National Mortgage Association.

Today I am appearing before you as the authorized spokesman for the Institute of Internal Auditors, which is an international organization consisting of more than 24,000 members, most of whom are located in the United States and Canada. We are pleased to count among our members several hundred who are employees of the Federal Government in the various agency audit groups.

The institute has long been concerned with the adequacy of systems of internal accounting and administrative control and with the process of evaluating the effectiveness of internal control systems, both in government and in the private sector. You might say it is the No. 1 occupational activity of our members.

We are, therefore, very pleased to have been invited to testify before this commitee on the subject of the Financial Integrity Act of 1981, S. 864.

We wholeheartedly endorse the concept of annual reporting on internal controls by Federal agency executives for the following reasons:

One, numerous audit reports issued by the GAO and statements made by former Comptroller General Elmer B. Staats have cited serious deficiencies in Federal agency internal control systems.

Similarly, the American press has frequently reported these deficiencies and numerous actual instances of major abuse or mismanagement of government programs. Thus, there would appear to be both a real need to strengthen agency control systems and an equally important need to demonstrate to the public that the government is acting responsibly to curtail waste of the American taxpayer's resources.

Two, in view of the aforementioned real and perceived problems, it appears necessary to reaffirm the Federal agency executive's responsibility and accountability for maintaining effective internal accounting and administrative controls.

Three, by requiring that formal annual reports on internal controls be submitted to the President and made available to the Congress, the relative importance of maintaining effective control systems, in relation to other aspects of agency operations, is greatly and properly increased. Thus, this aspect of the agency executive's responsibility will receive greater attention.

Four, finally, and perhaps most importantly, the required disclosure of any inadequacy or material weakness in internal controls will improve Federal executive and congressional awareness of the existence of any major problems in the systems, and the means of solving those problems. This requirement will also facilitate the tracking of future improvements in the internal control systems.

We recommend, however, that the annual opinion expressed by the head of each agency be limited to the major control systems which are essential to ensure that the agency achieves its objectives effectively, efficiently and economically. An opinion of this type should prevent the agencies from being unnecessarily burdened in administering the requirements of this act.

We would also like to express our support for provisions in the proposed legislation which require the investigation of any allegation that false or misleading information was provided in connection with the evaluation of internal control systems or in connection with the preparation of the annual report on internal controls. Such provisions serve to underscore the seriousness of internal control evaluations and reports, and improve the reliability of such evaluations and reports.

Although not directly related to any specific provisions of the proposed legislation, we thought it might be useful to this committee for us to state some of the major conclusions relating to internal control systems which we have developed by working with them in the private sector.

We have found that the most important determinant of the effectiveness of an internal control system is top management attitude concerning the importance of controls. When top management actively participates in establishing organizational controls and procedures and insists upon prompt correction of any deficiencies disclosed by their internal auditors or others, then the control con-

sciousness of the entire organization is enhanced, and the system of internal control functions more effectively.

Also, in well-managed organizations, it is common to establish a senior executive position with specific responsibility for financial management and control. The typical title for this position is vice president, finance, and the position is usually filled by someone having a strong background in accounting and management. The key to success is to designate an appropriately qualified senior executive whose primary responsibility is financial management and control.

We believe the Financial Integrity Act of 1981 will promote improved agency executive attitudes toward the importance of maintaining effective internal control systems and, thereby, foster increased attention toward the identification and correction of any deficiencies in such systems. In addition, we believe that the abuses of the past have caused a crisis of confidence in Federal Government programs and agencies as stated in the bill and that the public deserves to know that both the Congress and the administration are concerned about the problem and are working to insure sound management in the future. Accordingly, we strongly support the introduction and passage of this legislation.

For additional information concerning the importance of reporting on internal controls in the public sector, I would like to refer the committee to an excellent article which appears in the October 1981 issue of the Internal Auditor Journal. It is entitled, "Mandated Public Sector Internal Control Systems," authored by John H. Evans III, Barry L. Lewis, and James M. Patton, three professors with the graduate school of business of the University of Pittsburgh.

With your permission, I would offer this article to the committee for inclusion in the record.

Senator EAGLETON. It will be made a part of the record.

[The article referred to follows:]

[From the Internal Auditor, October 1981]

MANDATED PUBLIC SECTOR INTERNAL CONTROL SYSTEMS

(By John H. Evans III, Ph. D.; Barry L. Lewis, Ph. D. CPA; and James M. Patton, Ph. D. CPA)

The Foreign Corrupt Practices Act of 1977 (FCPA) dramatically increased the responsibilities of internal auditors and corporate managers with respect to internal accounting control systems. Because the FCPA amended the federal securities laws to incorporate the requirements of installing and monitoring adequate internal accounting controls, private enterprise managements are being forced to take a more active role in ensuring the reliability of their firms' financial records and reports.

Some observers have suggested that similar requirements should exist for managers in the public sector. Price Waterhouse & Co., for example, advocated the publication of annual executive reports by municipal chief executive officers.[1] This approach was also endorsed by the U.S. comptroller general.[2] In addition, proposals in the Congress (such as The Financial Integrity Act of 1980. The Federal Managers Accountability Act of 1981, and so forth) indicate increased legislative interest in the public sector internal controls and accountability.

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[1] Price Waterhouse & Co. "Enhancing Government Accountability" (New York: Price Waterhouse & Co., 1979).

[2] Elmer B. Staats, "Expanding Role of Accounting in our Economy," Government Accountants Journal (Fall, 1979). pp. 5–11

Our purpose is to present and analyze some justifications for requiring public sector managements to maintain and report on internal controls. The analysis here focuses on the relationship between public entities and their constituencies.

INTERNAL CONTROL

There is considerable agreement concerning the conceptual definition of an internal control system. Both the American Institute of Certified Public Accountants (AICPA) and the U.S. General Accounting Office (GAO) define internal control as the organizational plan and all coordinate measures adopted to safeguard assets, check the accuracy and reliability of accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies.[3] In addition to a commonly held conceptual definition of internal control, there is also general agreement as to some of the important qualitative characteristics which should exist in a satisfactory system of internal accounting control. These include:[4]

A plan of organization which provides appropriate segregation of functional responsibilities.

A system of authorization and record procedures adequate to provide reasonable accounting control over assets, liabilities, revenues, and expenses.

Sound practices to be followed in performance of duties and functions of each of the organizational departments.

Personnel of quality commensurate with responsibilities.

An effective system of internal review.

Despite the apparent agreement concerning the definition and desirable qualitative characteristics of internal control, there has been no formal development of a single standardized control system. This is, in part, because internal control is usually viewed as a means to an end rather than an end in itself. For example, the Standards for the Professional Practice of Internal Auditing states:[5]

"The purpose of the review for adequacy of the system of internal control is to ascertain whether the system established provides reasonable assurance that the organization's objectives and goals will be met efficiently and economically."

Similarly, a GOA examination and evaluation standards states.[6]

"An evaluation is to be made of the system of internal control to assess the extent it can be relied upon to ensure accurate information, to ensure compliance with laws and regulations, and to provide for efficient and effective operations."

In each situation, concentration is placed on the internal controls which relate to the specific management or audit objectives. For example, management, through its own internal audit staff, uses the internal control system to help exercise control over operations. In addition, internal control systems have served a major role in the independent audit of external financial reports. No single system of internal control is likely to be sufficient for all such objectives. Thus, different control systems have been developed as means to different ends.

AN END IN ITSELF

During the mid-1970s, the Securities and Exchange Commission (SEC) became aware of illegal or questionable payments made by corporations for domestic political purposes and for the bribery of foreign officials. In many cases, these payments were made possible by a direct circumvention of the corporations' internal control systems by various levels of management. Recommendations by the SEC to the U.S. Congress eventually led to the passage of the Foreign Corrupt Practices Act of 1977 (an amendment to the Securities Exchange Act of 1934).

Among other things, the FCPA requires all publicly held companies to maintain accurate records which fairly reflect transactions and to divise and maintain an adequate system of internal control. Thus, where poor internal accounting control in years past simply posed a problem in applying auditing standards, the FCPA made it a violation of federal law. Clearly, the intent of the FCPA was to highlight the

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[3] American Institute of Certified Public Accountants, "Statement on Auditing Standards, No. 1" (New York: American Institute of Certified Public Accountants. 1973), and Government Accounting Office. "Standards for Audit of Governmental Organizations, Programs, Activities & Functions" (Washington, D.C.: U.S. Government Printing Office, 1973).

[4] Ibid, "Standards for Audit of Governmental Organizations, Programs, Actvities & Functions."

[5] The Institute of Internal Auditors, Inc. "Standards for the Professional Practice of Internal Auditing" (Altamonte Springs, Florida: The Institute of Internal Auditors, Inc. 1978). Section 300.02.

[6] Ibid., "Standards for Audit of Governmental Organizations, Programs, Activities & Functions."

responsibility of private enterprise management to ensure that transactions and corporate assets are controlled.

These requirements represent a dramatic change in both the scope and purpose of auditor and management involvement in the internal control system. The maintenance of a good internal control system has become an end in itself.

To our knowledge, there are no FCPA-type requirements currently in force in the public sector. Although references are made to internal control in the rules of many state and federal agencies, the references are usually made in the context of requiring the application of generally accepted auditing standards during an audit examination.

For example, the GAO's fourth examination and evaluation standard requires an evaluation of the internal control system in order to determine the extent to which the auditor can rely on the system.[7] However, the audit objective is not the system; the objective is to determine the appropriate level of reliance on the system.

Proposed federal legislation (such as H.R. 8006, H.R. 1526, S. 3026) could lead to FCPA-type responsibilities and exposure for some public-sector managers. This extension of the concept of internal control as an end in itself would have significant implications for public-sector managers and internal auditors.

COMPARING PUBLIC AND PRIVATE SECTORS

Does the requirement for management to maintain and report on the quality of internal control in private-sector corporations imply that similar requirements are desirable in the public sector? The answer to this question must be related to differences between private- and public-sector organizations. We can analyze these differences both in terms of accounting objectives in the two sectors and in terms of economic incentives operating in each sector.

ACCOUNTING OBJECTIVES

The recent FASB Statement of Financial Accounting Concepts No. 4, Objectives of Financial Reporting by Nonbusiness Organizations, reveals many similarities with the FASB's earlier statement Objectives of Financial [8] Reporting by Business Enterprises.[9] For example, both statements include as a general goal the provision of financial information that is useful to resource providers (donors, taxpayers, creditirs, and so on) in allocating their resources more effectively. Further, the FASB contends that both the public and private sectors are concerned with providing information about the discharge of stewardship responsibilities and information about the economic resources and obligations of the organization. In addition, both sets of objectives state that information should be provided about an entity's performance during a period, about how cash is obtained and spent, about debt and the repayment of the debt, and about other factors affecting liquidity.

In spite of these similarities in the FASB statements of objectives, public-sector accounting principles have traditionally been more concerned with control of expenditures than with measurement of income. This emphasis is particularly clear in the municipal reporting principles promulgated by the National Council on Governmental Accounting.[10] The municipal use of fund accounting, formal budgetary accounts, and the modified accrual basis of accounting in governmental funds illustrate the emphasis on control.

This apparent, perceived need for the control of public-sector-input factors is an important difference in the emphaisis of accounting objectives in the two sectors. It is also consistent with proposals for extending the FCPA to the public sector; the emphasis on public-sector control could be enhanced. Thus, the need for FCPA-type requirements seems to be at least as desirable (in terms of accounting objectives) in the public sector as it is in the private sector.

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[7] Ibid., "Standards for Audit of Governmental Organizations, Programs, Activities & Functions."

[8] Financial Accounting Standards Board. "Objectives of Financial Reporting by Nonbusiness Organizations." Statement of Financial Accounting Concepts No. 4 (Stamford, Conn.: Financial Accounting Standards Board, 1980).

[9] Financial Accounting Standards Board. "Objectives of Financial Reporting by Business Enterprises." Statement of Financial Accounting Concepts No. 1 (Stamford, Connecticut: Financial Accounting Standards Board, 1978).

[10] National Council on Governmental Accounting. "Governmental Accounting and Financial Reporting Principles." National Council on Governmental Accounting Statement 1 (Chicago, Illinois: Municipal Finance Officers Association, 1979).

ECONOMIC INCENTIVES—PRIVATE SECTOR

The primary objective of requiring private-enterprise managements to report on internal control in the FCPA is to reduce the incidence of fraud, waste, and abuse by improving the effective quality of internal control in the corporations concerned. Improvements in internal control should result from management's becoming better informed about the existing internal control system and making adjustments as a reaction to the increased liability imposed by the FCPA. The increased liability incentive operates by making it very costly for management to be caught without an adequate system of internal controls. FCPA fixes clear responsibility and heavy penalties on management, so management finds it in its own interest to be quite certain that very good controls exist.

ECONOMIC INCENTIVES—PUBLIC SECTOR

There are two reasons for believing that FCPA-type requirements are at least as desirable in the public sector as in the private sector: first, the public sector's lack of effective "market" monitoring which accompanies concentrated private ownership [11] and, second, the fragmented nature of authority and responsibility in the public sector.

Market monitoring.

The first reason suggests that the existence of a market in which shares of private-sector firms are traded should significantly improve the quality of internal control systems of the traded firms. Private ownership provides the incentive for individuals to identity existing inefficiencies for the purpose of personal gain. If, for example, a firm is being run inefficiently because a weak control system encourages corruption and ineffective management practices, the actual market value of the firm will be reduced below its potential value. Thus, an opportunity exists for a takeover of the firm, removal of management, installation of an improved control system, and an increased value of the firm with the gain in value accruing to the individuals who initiated the takeover. It is also important to note that the same process may take place without so radical a change in ownership and management. In a firm with one or more large shareholders, the large shareholders have a substantial, direct stake in the quality of the firm's internal control system. Therefore, these shareholders have an incentive to investigate (personally or through individuals acting in their behalf) the quality of existing control systems. The key condition is that someone has sufficient incentive to expend the resources necessary to ensure that effective controls are employed. Sufficient motivation to expend those resources depends on the ability to capitalize the benefits of control systems and on the concentration of ownership interest.

The theory described above cannot be directly applied to the public sector. Clearly, fundamental differences exist in both the capitalization and concentration aspects of "market" monitoring for public versus private organizations. The absence of a direct market for ownership shares of public-sector enterprises is one obvious distinction. Although the market for local real estate may act to capitalize the effects of the performance of local governments to some extent,[12] high costs of buying and selling real estate limit the effectiveness of this market as a capitalization process. In addition, voting rights cannot be bought and sold as shares of a corporation, preventing the necessary concentration of interest. Therefore, market monitoring the public sector is likely to be significantly less effective than in the private sector.

In summary, the first ecomomic justification for mandated public-sector internal control systems is that certain built-in safeguards which operate automatically in the private sector are likely to be much less effective or nonexistent in the public sector. The automatic safeguards in the private sector are based on the self-interested, profit-maximizing behavior of parties who have significant stakes in the firm's efficieny. The private-sector incentive is that eliminating any inefficiency (such as that related to the internal control system) should yield a significant profit to those with large ownership shares. Although each person certainly has a stake in efficiency in the public sector, no individual has enough personally at stake to make it worthwhile for him or her to monitor performance very closely. Without this automatic safeguard continually at work, public-sector organizations can be expected to

[11] A Alchian. "Some Implications of Recognition of Property Right Transactions Costs," discussion paper. University of California, Los Angeles (1975) and Jerold L. Zimmerman, "The Municipal Accounting Maze An Analysis of Political Incentives," Journal of Accounting Research Supplement (1977), pp. 107–144.

[12] Hold. "The Municipal Accounting Maze: An Analysis of Political Incentives."

encounter greater difficulities with fraud. waste, and abuse than would private-sector firms. This results in a greater potential benefit of mechanisms to control such problems in the public sector. This, we conclude that explicit reporting requirements are likely to be even more beneficial in the public sector than the private sector.

Fragmented nature

The second reason that public-sector application of FCPA-type requirements is likely to be at least as worthwhile as private-sector application is the generally fragmented nature of authority and responsibility in public organizations. Although this condition is related to the lack of private-market monitoring, it is useful to discuss it separately.

Banfield called fragmentation of authority in government "a conspicuous and distinctive feature of the American political system" whose governmental bodies "have objectives that are numerous, unordered, vague and ambiguous, and mutually antagonistic if not down-right contradictory."[13] He argues that this lack of centralized direction makes fraud, waste, and abuse more likely because of the absence of strong and consistent incentives for any central objectives of the organization.

Related to the fragmentation-of-authority issue is the lack of "relatively clear, quantified demand indicators, goals, and performance measures" in the public sector.[14] In the private sector, quantities such as prices, sales, and profits are throught to provide relatively unambiguous indicators of progress toward goals. These measures help promote efficiency by providing input to decisions as well as feedback on results so that corrective action is facilitated. In the public sector, one is likely to find more ambiguous measures of progress and, simultaneously, a larger array of competing objectives to the served because of the fragmentation feature. As a result of a lack of market forces and a profit motive, fragmented authority and ambiguous goals weaken the pressure toward efficiency which might restrict fraud, waste, and abuse in the public sector.

A related feature of public-sector organizations is its reliance on legal forms and constraints. Thus, one finds a "proliferation of formal specifications and controls by statute, court rulings."[15] In other words, when output is so difficult to measure, the natural tendency is to resort to very detailed specifications of the proper inputs. This feature is importnt because it is consistent with the proposal that FCPA-type requirements be extended to the public sector. Imposing the requirements would serve as another attempt to further constrain or control inputs to the public-sector production process. This form of influence is consistent with what has been broadly recognized as a reliance on input constraints in the public sector in order to deal with the lack of the desired output measures.

To summarize, the key to public-sector application of control-system-reporting requirements is the absence of effective market monitoring. Without the market monitoring which operates when ownership is concentrated and effects are capitalized, public-sector organizations become fragmented; and pressure for internal control system quality is reduced. With reduced pressure, there exists greater opportunities for fraud. waste, and abuse in the fragmented organizations. The requirement to maintain and report on adequate control systems in the public sector is intended to reduce fraud, waste, and abuse. Official who realize they will be held personally responsible if inadequate controls are detected have stronge incentive to assure that controls are adequate. The use of such imposed incentives appears even more appropriate in the pubic sector than in the private because of the lack of alternative incentives for efficiency.

CONCLUSION

The FCPA was enacted to hold private-enteprise managements accountable for the control of financial assets and for the accuracy of the financial records of the corporation. Thus, a federal law has established the responsibility of corporations to have adequate systems of internal controls. One purpose of the imposition of the federal law was to reduce fraud, waste, and abuse in the private sector.

Our concern has been the problem of fraud, waste, and abuse in the public sector. In light of the lack of market forces to guide public management, we believe that similar requirements in the public sector could be an effective and efficient method

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[13] Edward G. Banfield, "Corruption as a Feature of Governmental Organization," *Journal of Law and Economics* (December 1975). pp. 587–606.

[14] Hal G. Rainey, Robert W. Backoff, and Charles H. Levine, "Comparing Public and Private Organizations," *Public Administration Review* (March–April 1976). pp. 233–244.

[15] *Ibid.*, p. 238.

of deterring fraud, waste, and abuse. The behavioral and economic incentives created by such a system are even more likely to be necessary in the public sector than they are in their current application in the private sector. This theoretical justification lends support to federal moves to extend FCPA-type requirements to the public sector. If such requirements are imposed, public-sector managements and internal auditors should be prepared to deal with the additional focus on internal controls as an end to itself.

IMPLEMENTATION ISSUES

One potential implementation problem is that it may be difficult to identify the appropriate individual in public-sector organizations to take responsibility for a declaration concerning the existence and quality of internal controls. In private enterprise, the chairman of the board or the chief executive is clearly responsible for the actions of the firm. But because of fragmentation of authority, the responsible individual may not be so easy to identify in some public-sector organizations.

A second potential implementation problem is that our analysis has not explicitly considered the direct and indirect costs of imposing a public-sector-internal-control-reporting requirement. The new requirement can be expected to directly produce significant incremental accounting and auditing costs. In addition, the new reporting responsibility may produce significant indirect costs by exacerbating the potential conflict among governmental officials. These direct and indirect costs have not been measured or analyzed and may limit the desirability of extending FCPA-type reporting requirements to the public sector.

Mr. WATSEN. Thank you. Mr. Chairman, that completes my prepared statement.

I will be pleased to respond to any questions you may have.

Senator EAGLETON. Are you familiar with Circular A-123 as testified to by Dr. Harper?

Mr. WATSEN. I have seen it. I am not intimately familiar with it, but I am aware of it.

Senator EAGLETON. Implicit in his testimony is that Circular A-123, at least for the moment, does the job. You disagree with that, I take it in your support of this legislation? You think we should go forward with it and not be satisfied with Circular A-123 in an of and by itself?

Mr. WATSEN. Yes, sir, I would. I believe it is an important step in the right direction, but, as I stated, and as I listened to the other witnesses today, the permanence of legislation, the importance of getting the signature of the chief executive of the agency, are very important considerations; and also, legislation is the means by which Congress can show to the public that it is concerned, and, in fact, is doing something about monitoring the problem as well.

Senator EAGLETON. With that observation as well, Mr. Watsen, thank you very much for being with us today. My thanks to all of the excellent witnesses that we have before us. That concludes today's hearing on the instant matter.

[Whereupon, at 1:30 p.m., the committee adjourned subject to call of the Chair.]

97TH CONGRESS
1ST SESSION

S. 864

To amend the Accounting and Auditing Act of 1950 to require ongoing evaluations and reports on the adequacy of the systems of internal accounting and administrative control of each executive agency.

IN THE SENATE OF THE UNITED STATES

APRIL 2 (legislative day, FEBRUARY 16), 1981

Mr. EAGLETON (for himself, Mr. PERCY, Mr. MATHIAS, Mr. ROTH, Mr. CHILES, Mr. SASSER, Mr. PRYOR, Mr. LEVIN, and Mr. SARBANES) introduced the following bill; which was read twice and referred to the Committee on Governmental Affairs

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A BILL

To amend the Accounting and Auditing Act of 1950 to require ongoing evaluations and reports on the adequacy of the systems of internal accounting and administrative control of each executive agency.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SHORT TITLE

SECTION 1. This Act may be cited as the "Financial Integrity Act of 1981".

FINDINGS AND POLICY

SEC. 2. (a) The Congress hereby finds that—

(1) fraud, waste, and mismanagement have caused a serious crisis of confidence in Federal Government programs and agencies;

(2) fraud and errors in Federal programs are more likely to occur from a lack of effective systems of internal accounting and administrative control in the Federal agencies;

(3) effective systems of internal accounting and administrative control provide the basic foundation upon which a structure of public accountability must be built;

(4) effective systems of internal accounting and administrative control are necessary to provide assurance that Federal assets and funds are adequately safeguarded as well as to produce reliable financial information for the agency;

(5) systems of internal accounting and administrative control are necessarily dynamic and must be continuously evaluated and where necessary improved; and

(6) reports regarding the adequacy of the systems of internal accounting and administrative control of each Federal agency are necessary to enable the ex-

ecutive branch, the Congress, and the public to evaluate the agency's performance of its public responsibilities and accountability.

(b) It is hereby declared to be the policy of the United States that—

(1) each Federal agency must maintain effective systems of internal accounting and administrative control as an integral part of its management practices;

(2) the systems of internal accounting and administrative control of each Federal agency shall be evaluated on an ongoing basis and when detected, weaknesses must be promptly corrected; and

(3) all levels of management of the Federal agencies must involve themselves in assessing and strengthening the systems of internal accounting and administrative control to minimize fraud, errors, abuse, and waste of Government funds.

DEFINITIONS

SEC. 3. As used in this Act:

(a) The term "President" means the President of the United States.

(b) The term "Comptroller General" means the Comptroller General of the United States.

(c) The term "Director" means the Director of the Office of Management and Budget.

SEC. 4. Section 113 of the Accounting and Auditing Act of 1950, as amended (31 U.S.C. 66a), is amended by adding at the end thereof the following new subsection:

"(d)(1) To ensure that the requirements of subsection (a)(3) of this section are fully complied with, the head of each executive agency, which the Director determines to be covered by this subsection, shall prepare a report stating an opinion on the adequacy of the agency's systems of internal accounting and administrative control by December 31, 1982, and by December 31 following the end of each fiscal year thereafter.

"(2) The reports shall be signed by the head of each executive agency and addressed to the President. Such reports shall also be made available to Congress and the public.

"(3) By December 31, 1981, the Comptroller General, in consultation with the Director, shall establish a system of reporting and a general framework to guide the agencies in performing evaluations on their systems of internal accounting and administrative control. The Comptroller General, in consultation with the Director, may modify the format for the report or the framework for conducting the evaluations from time to time as deemed necessary.

"(4) Internal accounting and administrative controls are to be defined by the Comptroller General, and shall provide reasonable assurances that—

"(i) all obligations and costs were in compliance with applicable law;

"(ii) all funds, property, and other assets were safeguarded against waste, loss, unauthorized use, or misappropriation; and

"(iii) all revenues and expenditures applicable to agency operations were properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the assets.

Any inadequacy or material weaknesses in an agency's systems of internal accounting and administrative control which prevents the head of the agency from stating that the agency's systems of internal accounting and administrative control provided reasonable assurances that each of the objectives specified above were achieved shall be identified and the plans and schedule for correcting any such inadequacy described in detail.

"(5)(A) The Inspector General of an executive agency or, if no Inspector General exists for an agency, the head of the internal audit staff, shall receive and investigate any allegation that an employee of the agency provided false or misleading information in connection with the evaluation of the agency's systems of internal accounting and administrative control or in connection with the preparation of the annual

report on the systems of internal accounting and administrative control.

"(B) If, in connection with any investigation under subparagraph (a), the Inspector General or the head of the internal audit staff, as appropriate, determines that there is reasonable cause to believe that false or misleading information was provided, he shall report that determination to the head of the agency.

"(C) The head of the agency shall review any matter referred to him under subparagraph (b) and shall take action under chapter 75 of title 5, United States Code, or such other disciplinary or corrective action as he deems necessary.".

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